

CONTRACTUAL ASSURANCES OF FISCAL STABILITY

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Abstract

The case for fiscal stability clauses lies in the large size of the investment, long period required to recover investment and earn a return and lack of host country credibility. They can reduce the contractor's fiscal risk. This reduction in fiscal risk may come at the price of a lower take for the contractor, all other things equal. Fiscal stability clauses are an attempt to overcome the time inconsistency problem in government policies.

There are, in general, two formulations of the fiscal stability clause: the frozen law formulation, and the agree-to-negotiate formulation. The paper raises a number of practical issues: (1) the locked-in benefits may be unsustainable; (2) problems may arise in determining just what the fiscal laws were when the agreement was signed; (3) when the fiscal stability clause takes the agree-to-negotiate formulation, the offsetting change that would be appropriate under one set of assumptions would likely be too generous or not generous enough under a different set of assumptions; and (4) many fiscal stability clauses are asymmetric protecting the contractor from adverse changes but passing on changes beneficial to the contractor.

There are few examples where the fiscal stability clause has been invoked in arbitration or court proceedings. Embarking on this path may lead to irretrievable breakdown in relations between the host government and the contractors. For an investor, the real benefit of a fiscal stability clause may be to sow the seed of doubt in the host government that it might be invoked, and thereby promote appropriate behavior. Fiscal stability assurances do not necessarily prevent contract renegotiation, where fiscal regimes in place do not respond with adequate adaptability and progressivity. Fiscal stability clauses are not a panacea for a poorly designed fiscal regime. They are unlikely to be a substitute for a credible overall commitment by a government to maintenance of predictability in its fiscal regime.

INTRODUCTION

Mining and petroleum agreements governing the exploration and development of natural resources frequently include contractual assurances of stability. These stability clauses are intended as legally-binding commitments by the host country's government. The commitment may be for an initial period of years or for the length of the agreement. They may cover a broad-range of host country laws or be limited to fiscal laws or even certain provisions in the fiscal laws, such as tax and royalty rates. This paper primarily addresses contractual assurances of fiscal stability.² "Fiscal stability" here means stability and predictability in the taxation, production-sharing, pricing, or state participation rules that govern the division of proceeds from a resource project.³

Fiscal stability clauses are generally justified by: (1) the large size and the sunken nature of the initial investment, and (2) often a long period required to recover investment and earn a reasonable return, taken together with (3) a lack of credibility on behalf of the host country to abstain from changing the fiscal rules—possibly singling out high rent petroleum or mining operations—once the investment is sunk (the "time inconsistency problem").

It can be argued that the need for a fiscal stability clause is less compelling under certain conditions: a history of sound fiscal management, statutory and effective corporate tax rates in line with international rates, low tariff rates and non-imposition of taxes that distort investment and production decisions (e.g., asset taxes, excises on machinery), non-discrimination between domestic and foreign investors, a low level of corruption, a transparent tax policy process, and a reasonably efficient tax administration. Adaptability and progressivity in the fiscal regime may also serve as an alternative. There may also be other forms of intervention that reduce risk to investors (subsidies, infrastructure provision, perhaps even state equity shares). Fiscal stability clauses are more common in mining and petroleum agreements negotiated by developing or transition countries than in those negotiated by developed countries. Some developing countries with a significant petroleum sector, including Angola and Nigeria, and most developed countries, including Norway and the United Kingdom, do not grant fiscal stability clauses in their petroleum agreements.⁴

² Stability clauses have been used to insulate investors from having to implement new environmental and social laws. See, International Finance Corporation, "Stabilization Clauses and Human Rights," March 11, 2008.

³ Thus the paper is not concerned with fiscal stabilization in a macroeconomic sense.

⁴ Both Norway and the UK have fiscal regimes for North Sea petroleum projects that include the regular income tax and an additional tax to capture a share of the economic rents of the most profitable projects. The UK has changed its regime more frequently than Norway, and now applies two different regimes depending when the oil field was developed. Royalty was abolished in the UK in 2003. The Norwegian regime has been more stable although the royalty rates were changed from 10 percent to 8 and 16 percent in 1972; lifted for new fields in 1987; and later phased out. (See Nakhle (2008)).

This paper focuses on *contractual* assurances because these have emerged as the instrument of choice in preference to attempts to *legislate* for fiscal stability (Brown 1990, Cameron 2006). Although, in principle, it is feasible to have constitutional devices to constrain the freedom of a legislature to enact new laws, in practice this is rare in the fiscal arena. What parliaments enact parliaments may undo. For this reason, attempts to provide in law that a tax regime is immutable, or to guarantee the stability of contractual fiscal terms by converting the contract into law, are usually seen as insufficient in themselves. Governments may, however, bind themselves by contract to compensate (or exempt or indemnify) an investor, if changes to an agreed fiscal regime, or components of it, are made by law or otherwise. For this to be effective, it is necessary that the government has a clear power in law to make such a contract, that there is an acceptable mechanism for adjudicating an alleged breach (usually international arbitration), and that any award made as a result of the breach of the contract is enforceable. Enforceability commonly requires that, in respect of the particular contract, the government has waived the right to rely on immunity against such proceedings or awards that its sovereign status usually provides.⁵

Such contractual assurances take various forms. The most common are: (1) those that provide for exemption from or compensation for any specified fiscal change, and (2) those that provide for some form of “rebalancing” of contract terms to deal with a tax-induced change in the expected benefits to a party. There are very few known cases where alleged breaches of such assurances have been brought to arbitration or litigation, raising important questions about the real function of such assurances. In earlier times, however, many cases were brought by companies about actions by governments that were alleged to amount to expropriation. Legal review of fiscal stability clauses has therefore tended to proceed by analogy with these earlier circumstances.⁶

A. Mining and Petroleum Fiscal Regimes

The government, as resource owner, has a valuable asset in the ground. This asset—crude oil, natural gas, or hard minerals—can only be exploited once. To convert this asset into financial resources, the government may use various fiscal instruments that will attract investment as well as secure a reasonable share of economic rent for the government.⁷ The government can

⁵ A typical contract provision would state that: “the Government on behalf of the Republic hereby irrevocably waives any right to rely on sovereign immunity in respect of arbitral proceedings...and further waives claim to immunity [from enforcement proceedings] and [from execution of any award against property y or assets of Government that are used for a commercial purpose].”

⁶ Cameron (2006) and Cameron (2009, forthcoming) provide a comprehensive survey, see also Bernardini (2008).

⁷ Countries may also establish state-owned companies to explore and develop of natural resource deposits. This alternative is outside the scope of this paper which addresses fiscal stability clauses in petroleum and mining agreements between governments (or state-owned companies) and private investors.

collect revenue from the resource sector by a variety of tax and nontax instruments. Most countries collect the government share of economic rent either through a tax/royalty regime or a production sharing arrangement.⁸ Both types of fiscal regimes include production-based and profit-based levies. There may also be bonus payments and annual rental payments, but these are less important. In some countries, the government participates more directly in project development as a shareholder.

A tax/royalty regime may involve three levies: (1) a royalty to secure a minimum payment, (2) the regular income tax, and (3) an additional tax, such as a resource rent tax, to capture a larger share of the profits of the most profitable projects.

Under a production sharing arrangement there usually is an explicit royalty payment. In addition, the parties agree that the contractor will meet the exploration and development costs in return for a share of any production that may result. The contractor will have no right to be paid in the event that discovery and development does not occur. In principle, the government retains and disposes of its own share of petroleum or minerals extracted, though joint-marketing arrangements may be made with the contractor.

The mechanics of production sharing in principle are quite straightforward. The production sharing contract (PSC) will usually specify a portion of total production, which can be retained by the contractor to recover costs (“cost oil”). The remaining oil (including any surplus of cost oil over the amount needed for cost recovery) is termed “profit oil” and is divided between the government and the contractor according to some formula set out in the PSC.

A petroleum or mining agreement under a tax/royalty regime, a production sharing regime, or a hybrid of both may include a fiscal stability clause—the focus of this paper. Whether or not a natural resource agreement includes a fiscal stability clause, a robust fiscal regime will more likely ensure fiscal stability and reduce the pressure to renegotiate agreements. A robust fiscal regime is one that produces a reasonable sharing of risk and the economic rents between the governments and investors over a wide-range of outcomes where prices, costs, and the quality of any discoveries are uncertain. In general, a robust fiscal regime ensures that the government’s share of revenue increases when the natural resource project is highly profitable. A robust fiscal regime is therefore adaptable and progressive.

There is not one optimal fiscal regime suitable for all resource projects in all countries. Countries differ, most importantly in regard to exploration, development, and production costs; the size and quality of natural resource deposits; and investor perception of commercial and political risk. Ultimately, there is a market test for each country’s fiscal

⁸ Production-sharing arrangements are far less common for hard minerals than for petroleum.

regime—can the country attract investment in its petroleum or mining sectors? If not, the fiscal regime may be inappropriate.

B. Why Should Companies Want—and Governments Grant—Fiscal Stability Assurances?

Fiscal stability assurances are a possible answer to what is known as the time inconsistency (or dynamic inconsistency) problem in government policies. The problem occurs when a government announces a policy in advance (such as a tax regime), but after the fact finds it welfare-increasing to go back on the commitment implied by the policy.⁹ Although the reversal of the commitment might provide the greatest welfare over a short time horizon, the cost comes in perceptions that the government reneges on its promises, and has lost credibility. Future social welfare will then be reduced because the government can adopt only those policies that do not require it to have credibility. When “time-inconsistent” actions, such as a unilateral tax change, are an issue, then rules rather than discretionary policy making produce a better outcome. When discretionary policy is maintained, there may be underinvestment: companies become reluctant to invest where the weakness of their bargaining position, once investment is sunk, may be exploited. Fiscal stability assurances are one variety of “rules” that are used to overcome this problem.

Fear of future tax rises can produce sub-optimal investment decisions at each of the margins of exploration, development, and production. Petroleum and mining are both highly capital intensive, so that the risk of failure to go forward with investment in projects at the development stage has especially damaging effects. A credible commitment not to change tax terms once investment has been committed should, in principle, raise the level of investment. This applies both at the level of the country as a whole, for securing the optimal level of exploration and development investment overall, and within an individual project where incremental investment decisions can be made as production proceeds.¹⁰

Despite desirability of commitment to tax stability on these grounds, it is difficult to achieve. Firstly, the full life-cycle of a petroleum or mining project can be very long, and that of a petroleum or mineral province as a whole much longer. A typical planning horizon for the production phase of a large petroleum field might be 20 to 25 years, after an exploration and development phase that might have taken 10 years. A few large mines still operate around the world that are more than 100 years old;¹¹ among modern developments, productive lives in

⁹ This description of the problem draws on a note by Eric le Borgne (2006); the problem has been widely recognized since the work of Kydland and Prescott (1977) in the field of commitments to monetary policy.

¹⁰ For an extended discussion of these points, upon which we have drawn, see Osmundsen (2008).

¹¹ For example, the Ashanti GoldFields underground mine in Ghana.

excess of 25 years are common.¹² These horizons are far longer than the life expectancy of most governments.¹³ Governments may be able to make commitments of their own, but cannot bind the legislative competence of the state in future. Contractual assurances of fiscal stability represent efforts to navigate around this feature.

Secondly, it may be difficult for fiscal arrangements to envisage all possible economic outcomes. Pressures may arise from investors (in adverse circumstances) and from governments (when projects yield returns above expectations) for changes in terms. In addition, the substantial sunk and immobile capital element in a project makes it effectively impossible for investors to switch to other locations in the face of an adverse change in fiscal terms. One of the tasks in design of fiscal regimes is to improve their adaptability and progressivity, subject to an appropriate apportionment of risks, so that the probability of contract stability is raised.

Assurances of fiscal stability made by governments have features in common with other institutional devices designed to promote wider fiscal discipline. They may not be quite what they seem. A strict reading of the relevant legal texts may raise questions about the power of the government to make the assurance, about the construction and arbitration of a dispute under its provisions, or about the enforcement of any award. These questions, however, may not cover the underlying purposes of parties to an agreement.

Recent discussion of fiscal institutions and fiscal rules has suggested three hypotheses about the effectiveness of arrangements made to promote fiscal discipline (Debrun and Kumar, 2008). By analogy, these are useful in interpreting the operation of fiscal stability assurances.¹⁴

The first is the “commitment” hypothesis: the presumption that, by entering into a fiscal stability agreement, governments have given themselves incentives to abide by a set of fiscal terms, seen as appropriate prior to the investment commitment. Alternatively, this hypothesis can encompass the attempt of one arm of government to bind the actions of another, or of a present government to bind the actions of a future one, in the belief that the public interest is thereby served.

¹² Examples include the Freeport McMoran copper mine in West Papua, Indonesia, Escondida (and other mines) in Chile, El Cuajone and Toquepala in Peru, Bingham Canyon in Utah, USA.

¹³ An interesting exception is Botswana, where continuity of party rule by democratic election has accompanied substantial continuity of mineral contract arrangements.

¹⁴ These are not precise reformulations of the hypotheses set out by Debrun and Kumar, but possible views of fiscal stability assurances suggested by their wider analysis of fiscal institutions and rules.

The second is the “signaling” hypothesis. In this case, the “signal” is to other potential investors in the resource sector, first, that the government has a serious commitment to stability of fiscal terms, and, second, that if a project runs into difficulty it is not the result of government fiscal impositions. Alternatively, the “signal” could be interpreted as a signal of underlying competence, where the government is less likely to arrive in circumstances that it will need to turn to heavy resource taxes. On this interpretation, willingness to offer a fiscal stability assurance is part of the promotion of an attractive investment climate.

The third is the “smokescreen” hypothesis. This relates to the transparency of fiscal impositions on a project. A fiscal stability assurance could be constructed so that it remains in place, but when adherence to its full terms becomes too costly, governments “cheat” by use of devices not covered by the assurance. This hypothesis would explain efforts by companies to make such contractual assurances increasingly watertight. It would also pose challenges to attempts to restrict the scope of such assurances.¹⁵

Each of these will have a counterpart in company assumptions about the purpose and usefulness of a fiscal stability assurance. If companies believe they are a “commitment” device, they are likely to value the assurances, even if a company has no serious intention of invoking dispute proceedings under the assurance. If companies see them only as “signaling” devices (unless only competent governments are believed to signal), or still worse as a “smokescreen,” then they are likely to find them less valuable.

The case for fiscal stability clauses lies in the large size of the investment, long period required to recover investment and earn a return, and lack of host country credibility. Fiscal stability clauses, however, may not be in the best interest of the shareholders. Let us assume that fiscal stability clauses reduce fiscal risk. This reduction in risk may come at the price of a lower take for the contractor all other things equal. Instead of laying off the fiscal risk through a fiscal stability clause, the shareholders might be better off if the contractors accepted fiscal risk in exchange for a lower government take. The argument would hold if shareholders can adequately diversify their fiscal risk.

In a few cases, governments have explicitly charged an “insurance premium” for a fiscal stability assurance. Examples are more common in mining than in petroleum. In the case of mining, Peru charges a 2 percent premium on the income tax rate where the investor takes a stability assurance.¹⁶ Chile for many years offered a corporate income tax rate guaranteed for 10 years, but at a rate significantly higher than the general corporate income tax rate. Papua New Guinea introduced a premium on the income tax rate for the same purpose in 2002.

¹⁵ A frequent recommendation in FAD technical assistance.

¹⁶ Peru offers stability assurances under its general legislation, and a broader legal stability assurance under its mining legislation.

The difficulty with this argument (and with the insurance premium) is that the differential position of investors with and without fiscal stability assurances becomes a “license” for governments to change terms for those not protected. The contribution of a fiscal stability assurance to the overall credibility of the government’s commitment to maintain a tax regime over a long period may thus be undermined.

C. Fiscal Stability in Context

Stability of contract terms and the legal basis for a resource project encompasses more than fiscal stability alone. Peter Cameron describes the general notion of “stabilization” as “all of the mechanisms, contractual or otherwise, which aim to subject the contract provisions to specific economic and legal conditions which the parties considered appropriate at the time that the contract was concluded” (Cameron, 2006: 28).

A fiscal stability clause is a contractual guarantee included in petroleum or mining agreement. In reviewing an agreement, the first question to be asked is whether the fiscal stability provision was granted and approved with full legal authority. The authority for a government to negotiate resource agreements is usually included in a country’s petroleum or mining law, and this law may also include the authority for the government to include a fiscal stability clause in an agreement.

Some agreements contain fiscal provisions inconsistent with the country’s fiscal laws. In general, negotiated agreements—i.e., contracts—can not override a country’s enacted legislation. Adding a fiscal stability clause to a contract with fiscal provisions inconsistent with enacted legislation may give the contractor some rights under the contract, but it does not cure the inconsistency between the contract and the enacted legislation. When contract provisions are inconsistent with enacted legislation, the contract may be submitted to parliament for approval, which would give the contract the force of law. This approach has been used in Liberia, Sierra Leone and other countries.

Fiscal stability clauses are not always neatly packaged and they need to be read in the context of other provisions in the mining or petroleum agreement, the relevant laws of the country, bilateral tax treaties and bilateral investment treaties. First, fiscal stability may be enhanced by domestic legislation—the mining or petroleum law, the investment law, the company law, (and contractual assurances) ensuring national treatment,¹⁷ non-discrimination,¹⁸ and arbitration of disputes. Contracts sometimes provide for renegotiation of terms if both parties

¹⁷ National treatment provides that domestic and foreign investors can make investment in a country on the same terms.

¹⁸ Non-discrimination provides that there will be no discrimination between foreign investors from different countries.

agree. Some contracts also include “most-favored contractor” clauses, which provide that the contractor will be eligible for any benefits granted another contractor under a future agreement.

Second, there are two primary purposes of bilateral income tax treaties: (1) to mitigate double taxation of income and (2) to provide mutual assistance in combating tax avoidance and evasion. With respect to the first purpose, income tax treaties divide the taxing jurisdiction between the two countries that are party to the treaty and they usually include an article on the elimination of double taxation when a source of income is subject to tax in both contracting states. Treaties limit the right of a contracting state to tax capital gains, other than gains from immovable property (real estate), realized by a resident—an individual or a company—of the other contracting state.¹⁹ Treaties also provide for reduction in withholding taxes on dividends and interest income sourced in one contracting state and paid to a resident of the other contracting state.

Third, bilateral investment treaties set terms and conditions for foreign direct investment by residents from one contracting state in the other contracting state. These treaties usually include a number of guarantees—fair and equitable treatment, protections from expropriation, free transfers. They also allow for recourse to international arbitration. These guarantees, of course, may also be included in a country’s investment law.

E. Two Formulations of the Fiscal Stability Clause

In contracts, there are, in general, two formulations of the fiscal stability clause. Under the frozen law formulation, the laws in force when the agreement is signed are frozen for the life of the contract or for a period of years. In Liberia, the Amended Mittal Mineral Development Agreement²⁰ provides an example of the frozen law formulation:

...the CONCESSIONAIRE and its Associates shall be subject to taxation under the provisions of the Minerals and Mining Law and the Code and all regulations, orders and decrees promulgated thereunder, all interpretations (written or oral) thereof and all methods of implementation and administration thereof by any agency or instrumentality of the GOVERNMENT (the Code and all such regulations, interpretations and methods of implementation and administration collectively, the “Tax Corpus”), in each case as in effect as of the date of this Agreement.... For the avoidance of doubt, any amendments, additions, revisions, modifications or other changes to the Tax Corpus made after the Amendment

¹⁹ Some treaties provide that gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State.

²⁰ The Mineral Development Agreement between the Government of the Republic of Liberia and Mittal Steel Holdings N.V. dated August 17, 2005, and the Amendment thereto dated December 28, 2006.

Effective Date shall not be applicable to the CONCESSIONAIRE. Furthermore, any future amendment, additions, revisions, modifications or other changes to any Law (other than the Tax Corpus) applicable to the CONCESSIONAIRE or the Operations that would have the effect of imposing an additional or higher tax, duty, custom, royalty or similar charge on the CONCESSIONAIRE will not apply to the CONCESSIONAIRE to the extent it would require the CONCESSIONAIRE to pay such additional tax, duty, royalty or charge.

Under the agree-to-negotiate formulation, the parties to the contract agree to negotiate in good faith to maintain economic equilibrium if there are any adverse changes in the laws (or regulations). The Kurdistan Region model production-sharing agreement²¹ provides an example of the agree-to-negotiate formulation:

43.2 The obligations of the CONTRACTOR resulting from this Contract shall not be aggravated by the GOVERNMENT and the general and overall equilibrium between the Parties under this Contract shall not be affected in a substantial and lasting manner.

43.3 The GOVERNMENT guarantees to the CONTRACTOR, for the entire duration of this Contract, that it will maintain the stability of the fiscal and economic conditions of this Contract, as they result from this Contract and as they result from the laws and regulations in force on the date of signature of this Contract. The CONTRACTOR has entered into this Contract on the basis of the legal, fiscal and economic framework prevailing at the Effective Date. If, at any time after the Effective Date, there is any change in the legal, fiscal and/or economic framework under the Kurdistan Region Law or other Law applicable in the Kurdistan Region which detrimentally affects the CONTRACTOR, the terms and conditions of the Contract shall be altered so as to restore the CONTRACTOR to the same overall economic position as that which CONTRACTOR would have been in, had no such change in the legal, fiscal and/or economic framework occurred.

43.4 If the CONTRACTOR believes that its economic position has been detrimentally affected as provided in Article 43.3, upon the CONTRACTOR's written request, the Parties shall meet to agree on any necessary measures or making any appropriate amendments to the terms of this Contract with a view to re-establishing the economic equilibrium between the Parties and restoring the CONTRACTOR to the position it was in prior to the occurrence of the change having such detrimental effect. Should the Parties be unable to agree on the merit of amending this Contract and/or on any amendments to be made to this Contract within ninety (90) days of CONTRACTOR's request (or such other period as may be agreed by the Parties), the

²¹ http://www.macleoddixon.com/documents/Draft_Kudrdistan_Region_Production_Sharing_Contract_June_2007.pdf (searched June 12, 2008).

CONTRACTOR may refer the matter in dispute to arbitration as provided in Article 42.1.

43.5 Without prejudice to the generality of the foregoing, the CONTRACTOR shall be entitled to request the benefit of any future changes to the petroleum legislation or any other legislation complementing, amending or replacing it.

Agree-to-negotiate fiscal stability clauses are more common than frozen law clauses, particularly in recent years.²² Unless the clause is specified in great detail it may not be worth much. Under most resource agreements, the parties can by mutual agreement always agree to amend the agreement and thus an agree-to-negotiate fiscal stability clause may not add much protection for the contractor.

Under production-sharing agreements, the contractors usually pay income tax on their share of production, in part, because the contractors want an income tax in the host country that will be creditable against the income tax liability in the home country.²³ Some production sharing agreements provide that the income tax will be paid out of the government's share of production, and under these agreements the government's share of production would be higher, all other things equal (as there is no separate income tax payment). A significant advantage of this approach is that the contractors have fiscal stability with respect to the income tax—any future changes in the tax rules would affect only the allocation of the government's share between tax and nontax oil. This option for achieving fiscal stability, which is not very widespread, is not discussed further in this paper.

When tax laws are changed, existing project or investments are often “grandfathered”; that is, exempted from the new rules. Grandfathering prevents retroactivity and ensures transitional equity, or so it is said. Grandfathering can also provide a kind of fiscal stability.

In general, when countries change their capital recovery rules making them less generous, the costs of investments that have already been made would be allowed to be recovered under the old rules. Similarly, if a country repeals its provisions for tax holidays, investments that currently are enjoying tax holidays would be grandfathered as long as they continue to meet

²² However, as most mining and petroleum agreements are confidential, it is not possible to quantify trends in the use of fiscal stability clauses.

²³ The United States and the United Kingdom are home countries that tax world-wide income of their resident companies. In general, when distributions are remitted from a foreign subsidiary to a parent company in the United States or the United Kingdom, the parent company includes the dividend and the underlying corporate tax and any withholding tax on the dividend in taxable income. The parent company then is able to claim a foreign tax credit for the income and withholding tax paid in the host country up to the amount of home country's tax on the foreign source income. Under U.S. tax rules, a foreign income tax paid out of the government's share will only qualify for the foreign tax credit if certain technical conditions are met.

any prior conditions. The repeal of tax holidays would only apply to new investments. Similarly, if a country repeals tax exemption for interest on government bonds, existing bondholders would usually be grandfathered, as they otherwise would incur a capital loss. However, if the general tax rate is increased, the tax rate on income from prior investments would not be grandfathered. Changing the tax rate that applies to income earned in the future (even from prior investments) is not viewed as a retroactive tax change and therefore grandfathering is not appropriate. Thus the general practice of grandfathering certain tax changes affecting prior investments does not provide fiscal stability for all tax changes and thus is more limited than the fiscal stability clauses included in petroleum and mining agreements.²⁴

D. Issues

Fiscal stability clauses raise a number of practical issues: (1) unsustainable benefits, (2) the frozen or reference law, (3) the offsetting change, (4) the one-way bet, and (5) fiscal stability as an option.

Unsustainable benefits

Fiscal stability, by locking in domestic laws as of the date the mining or petroleum agreement is signed, may provide contractors with unsustainable benefits, when there is significant change in circumstances or when the locked-in law is defective. The laws, of course, can be amended, but the amendments will not apply to existing contracts covered by the typical fiscal stability clause, unless the clauses are somehow rescinded, or there is voluntary agreement that amended arrangements will apply. We illustrate with a couple of examples.

Zambia

Mining Development Agreements were made from 1997 onwards in the context of privatization of the state-owned copper mines (Zambia Consolidated Copper Mines, ZCCM). At the time, the country was desperate for investment after a long period of decline at ZCCM, and with metal prices low. In exchange for substantial commitments to redevelop mines, investors acquiring assets were given fiscal terms that included a royalty rate of 0.6 percent, an income tax rate of 25 percent, privileges on withholding taxes and customs duties, in addition to the existing provisions of law on expensing of exploration and development capital expenditure.²⁵ Their obligations to share profits with the legacy ZCCM

²⁴ Professor Michael Graetz has argued that grandfathering is economically inefficient although he does favor some phased-in relief. See, Graetz (1977), This seminal article by Professor Graetz has generated a rich literature on whether grandfathering and other forms of transitional relief.

²⁵ The revisions to legislated fiscal terms appear to have been sufficiently controversial that they were specifically backed by a retrospective amendment to the Mines and Minerals Act of 2002. The amendment, now
(continued...)

(through equity shares and price participation arrangements) were constrained by dividend distribution limits and lifetime maxima.

The agreements were successful in stimulating substantial reinvestment in the mines, despite the withdrawal of one major investor (apparently taking substantial losses) in 2002, just prior to the start of the recent commodity price boom. By 2006–07, however, the growth of mine production and exports was so fast, with world prices reaching record levels, that the government’s revenue take appeared paltry by comparison. The government acted first to revise the fiscal regime for new projects in 2007, and then in 2008 it amended the Mines and Minerals act to invalidate all existing Mining Development Agreements—thus also invalidating, under *Zambian Law*, the fiscal stability assurances. A new fiscal regime, containing a price-related windfall tax and a variable income tax, was introduced for the whole mining sector.

At the time of writing, no legal challenge to the government’s actions is apparent. These fiscal stability assurances were accompanied by international arbitration and a waiver of sovereign immunity.

Tanzania

In 1997–98, Tanzania introduced a new Mining Act (1998), and amended its Income Tax Act to provide a new fiscal regime for the mining sector. The sector was moribund, though with numerous discoveries from prior exploration, so the new law aimed at jump starting mine development decisions by offering improved security of tenure and generous fiscal terms.²⁶ The package was successful in encouraging mine development: some four new mines were developed prior to the first amendments of the scheme in 2001, with many more in subsequent years, and Tanzania is now the third largest gold producer in Africa (after South Africa and Ghana), from zero formal production in 1997. It was not successful, however, in generating substantial revenues for the government from these new mines.

Among other incentives, the law provided an additional (annual) capital allowance of 15 percent of unredeemed development capital expenditure (i.e., development capital expenditure that has not been offset against profits that would otherwise be subject to tax).²⁷

repealed, provided that the development agreement “may contain provisions which notwithstanding the provisions of any law or regulation shall be binding on the Republic....”

²⁶ Both Tanzania and Zambia exemplified an international pattern at the time. It should be recalled not only that the price of gold had fallen from a high of \$500 per oz in late 1987 to close below \$300 at the end of 1997, but also that the country was recently emerging from an extended period during which expropriations of both foreign and national businesses had been widespread.

²⁷ Not including exploration capital expenditure.

A similar provision (at 12 percent) existed in South Africa for gold mining capital expenditure.²⁸ This provision transformed the regular income tax into a modified resource rent tax (RRT),²⁹ assuming the 15 percent additional allowance approximates the contractor's opportunity cost of capital.

The 15 percent additional allowance applied to all unredeemed development costs. This led to a double dip. If all unredeemed capital costs are debt financed at 10 percent, no tax would be payable until the project has earned a 25 percent internal rate of return before tax and interest expense—a 10 percent return to pay the interest on the borrowed funds and an additional 15 percent return to cover the additional allowance.

Prevention of this outcome required that the 15 percent uplift would not apply to unredeemed capital expenditure which is debt financed. Alternatively, the law could have provided a denial of interest expense on debt used to finance assets subject to the additional capital allowance. The mining tax change also predated a reform of the liberal interest deduction provisions of the general Income Tax Act. Nevertheless, the law was clear: unredeemed development capital expenditure (uplifted by 15 percent) is offset each year against “gains or profits chargeable to tax,” which would be after interest expense is deducted.

Because of high leverage and low operating margins, these companies paid no income tax for a significant period. This position became unsustainable—especially when gold prices began to rise—once it became clear that Tanzania was to attract significant amounts of foreign investment to the mining sector.

In 2001, the 15 percent additional capital allowance (together with certain other incentives) was repealed for companies entering into a mining Development Agreement after July 1, 2001. Existing mines were grandfathered. When the new Income Tax Act of 2004 was adopted—a complete rewrite of the Income Tax Act of 1973—there was a general “grandfathering” rule for companies that have binding agreements with the government. In 2007, companies with fiscal stability assurances protecting the capital allowance, were reported to have agreed to forego the capital allowance in future and to have made significant payments of past tax that would have been due in the absence of the allowance. (ICMM, 2008).

²⁸ See Van Blerck (1992), 13–3 to 13–12.

²⁹ A RRT is imposed only if the accumulated cash flow from the project is positive. The net negative cash flow (in the early years) is accumulated at an interest rate that, in theory, is equal to the contractor's opportunity cost of capital adjusted for risk. RRTs have been levied in Australia and Papua New Guinea, but in addition to the regular income tax not as a replacement for it.

Mongolia

The discovery of the Oyu Tolgoi copper/gold deposit by Ivanhoe Mines in 2001 brought international attention to the Mongolian mining sector. When this deposit is developed, the resulting mine could be one of the largest copper mines in the world. To this end, the government in 2007 negotiated an Investment Agreement with Ivanhoe, and its partner Rio Tinto.³⁰ The government submitted the agreement to Parliament for approval, as the agreement overrode current law in a number of respects. Without taking action on the agreement, Parliament passed it back to the government. Negotiations are stalled at the time of writing.

The Oyu Tolgoi Investment Agreement that was submitted to Parliament contained the frozen law approach to fiscal stability for a long list of taxes and fees, including the dog tax and inheritance and gift taxes.³¹ A major problem would have been that current income tax law is defective and would have conferred unintended benefits on the investor.³² For example, the law's provision relating to transfer pricing between related parties only covers a parent/subsidiary relationship. Thus, transactions between two companies controlled by a third company would not come under the income tax law's definition of a related party. If this defect is not corrected, mining companies would be able to shift profits by using transactions between "related companies" that fall outside the income tax law's restrictive definition of related party. The income tax provision relating to excess use of debt (thin capitalization) are also too restrictive as it applies only to related parties narrowly defined. There are other ambiguities in the provision.

The frozen or reference law

When a petroleum or mining agreement contains a fiscal stability clause, problems may arise in determining just what the fiscal laws were when the agreement was signed. During the effective period of the stability clause, the laws will be amended, possibly several times a year. They may be totally redrafted. By the 20th year of the contract, there is likely to be no one in the tax administration who remembers the fine points of the tax laws that applied 20 years ago. If the tax administration is dealing with a number of resource contracts signed over a period of years, contracts signed at different times, even during the same year, will be administered under a different set of fiscal laws, complicating tax administration.

³⁰ For a copy of the agreement, see <http://www.openforum.mn/index.php?coid=1835&cid=329> (searched June 5, 2008).

³¹ To our knowledge, companies do not pay inheritance and gift taxes.

³² There are other provisions that need liberalizing. For example, the loss carryover period is limited to two years.

The frozen or reference law for purposes of fiscal stability usually includes not just the actual law but all regulations, interpretations (which may or may not be publicly available), and all methods of implementation and administration.³³ Determining the “law” years ago can be a daunting task, though the companies benefiting are likely to maintain careful records.

Timor-Leste (formerly, East Timor) provides an example of the problems of determining frozen law. Before 1999, contractors in the “Zone of Cooperation” in the Timor Sea³⁴ were taxed in accordance with a treaty under both Australian and Indonesian law, with tax assessable under each reduced, in effect, by 50 percent to reflect the attribution of petroleum in the area. After Indonesia relinquished control of East Timor in 1999, the United Nations Transitional Administration in East Timor (UNTAET), acting on behalf of East Timor, agreed that the contractors would be taxed under East Timor’s law but incorporating Indonesian law, frozen as of October 25, 1999. Although new petroleum fiscal legislation and other tax laws have been enacted since the restoration of independence in 2002, specific exclusions were made for four pre-existing production sharing contract areas such that the frozen Indonesian law would apply. In the case of the one major project in what is now the joint development area (90 percent of petroleum attributable to Timor-Leste, 10 percent to Australia), the frozen Indonesian law is supplemented by a specific Timor-Leste tax law for the project, and by a tax stability agreement. In common with all projects in the joint area, taxation is also subject to the double taxation code under the Timor Sea Treaty. The tax stability agreement “freezes” the whole package as at January 1, 2002, but is a two-way street, as discussed below.

The offsetting change

When a fiscal stability clause requires the parties to the natural resource agreement to negotiate terms so as to restore the economic position of the contractor, there may be troubles reaching an agreement. These agree-to-negotiate stability clauses presume that the effect of the change in the fiscal terms can be appraised and an offsetting change agreed to. If there is no uncertainty about costs and revenues and agreement on an appropriate discount rate, the effect of the change in the fiscal terms may be quantifiable. Under these conditions, an increase in the income tax rate could be offset by a reduction in the royalty rate, but the changed fiscal regime would have different economic effects at the margin. Moreover, with uncertainty as to costs and revenues, the offsetting change that would be appropriate under

³³ See the Mittal agreement quoted earlier.

³⁴ The 1972 treaty between Australia and Indonesia establishing a seabed boundary between the two countries left a gap in the boundary in the Timor Sea, known then as the “Timor Gap.” This gap occurred because any seabed boundary between East Timor and Australia would have had to be established by Australia and Portugal. In 1975, Indonesia invaded East Timor. In 1989, Australia and Indonesia bilaterally concluded the Timor Gap Treaty in which they permitted the exploration and exploitation of petroleum resources in the area of disputed sovereignty.

one set of assumptions would likely be too generous or not generous enough under a different set of assumptions.

One possible approach would be for the parties each year ex post to determine the offsetting adjustment, possibly a payment from the state to the contractor—that is, use retrospective adjustments to restore the contractor’s economic position. This would require calculating pro forma tax returns under current law and old law each year. This would involve considerable administrative burden on the contractor and the government.

One-way bet

The fiscal stability clauses in many mining and petroleum agreements are asymmetric: protecting the contractor from adverse changes to the fiscal terms but passing on benefits of reductions in tax rates or other changes beneficial to the contractor, such as more liberal rules for cost recovery. If fiscal stability is a one-way bet and the government later wants to reduce tax rates and broaden the tax base, the company protected by the stability agreement will be entitled to the reduced rates but may not be subject to the provisions that broaden the tax base.³⁵ This can make future tax reform very difficult, especially if large contractors are protected by stability agreements that entitle them to all beneficial tax changes. Conferring future beneficial tax benefits on these contractors would provide them with a windfall. If a contractor wants a fiscal stability agreement, it would be reasonable for stability to be a two-way bet, which would be the case when the contractor is protected from unfavorable changes in the law and does benefit from favorable changes.

Of course, when the fiscal stability clause is a two-way bet, the government could, by statute, grant contractors the benefit of any new tax concessions, including rate reductions. Given changes in economic circumstances, this may be appropriate public policy.

As mentioned above, the Timor-Leste fiscal stability agreement for Bayu-Undan fixes tax parameters in both directions—the contractor does not benefit from tax reductions. This probably works well where the fiscal regime is in any case flexible, with strong reliance on profit and cash flow bases.

³⁵ Depending on the exact wording of the fiscal stability clause, a company protected by an agree-to-negotiate stability clause may only be able to negotiate an offsetting change if package of changes leaves the company in an adverse economic position. However, the Kurdistan model agreement, cited above, would allow the contractor to request the benefit of any future changes. In effect the contractor could cherry pick a balanced tax reform package combining, say, lower tax rates with less favorable capital recovery rules.

Fiscal Stability as an Option

When originally introduced in 1980, Chile's Foreign Investment Law (Decree Law 600) provided various investor protections and guarantees, including fiscal stability for 10 years (extended to 20 years for investments exceeding US\$50 million). In exchange for the guaranteed protection from changes in the income tax law, the investor was required to pay a combined corporate income tax and dividend withholding tax of 42 percent, excluding the specific mining tax. The general rate applicable on corporate profits and remittances at the time was 35 percent—7 percentage points lower. An investor could waive fiscal stability but only one time. These arrangements have since been amended (Chile, Foreign Investment Committee, 2005), but a fiscal stability option remains available.

Mining companies have generally opted for fiscal stability and the higher tax rate in the early years of the project when the project is producing tax losses and before any profits are remitted. However, once the project begins to produce taxable profits, companies waive fiscal stability and take their chances that the generally applicable tax rate on profits and remittances will not be increased to a rate above 42 percent. Nonetheless, during the start up phase, the option for fiscal stability is an important guarantee for the investor.

The pattern of events in Tanzania and Zambia lends some support to this idea. Although, in retrospect, the fiscal regimes granted to mining in those countries proved too favorable to investors to be politically sustainable when circumstances changed, the initial packages did succeed in promoting the desired increase investment. These packages consisted of both the favorable fiscal regimes and the contractual assurance of fiscal stability. A substantial expansion of the tax base in the mineral sector occurred. Tanzania first revised terms for subsequent investors—a standard procedure in petroleum producing countries when risks are reduced and prospectivity³⁶ is improved—and then implemented measures agreed by consensus to increase its take from existing mines. Zambia acted in a more radical fashion by legislating a revised regime without undertaking prior renegotiations.

In both these cases, the fiscal stability assurance initially acted as a “signaling” device, but it was not necessarily tenable through the originally specified term. Whether or not a government's actions in changing a fiscal regime, despite a fiscal stability assurance, prove acceptable may be a function of (1) the rapidity with which an investor has recovered initial outlays, with an acceptable rate of return, while the assurance is valid, and (2) the likelihood that, thereafter and under changed or unpredictable fiscal terms, established investors can continue to anticipate sufficient incremental returns.

³⁶ “Prospectivity” means the likelihood of making a petroleum discovery, and then also the likelihood that any discovery can be commercially developed.

These possibilities are inconsistent with a strict interpretation of *pacta sunt servanda* but they are consistent with some of the possible motivations for fiscal stability assurances sketched earlier in this paper.

G. Invoking Fiscal Stability Clause

There are few examples where the fiscal stability clause has been invoked in arbitration or court proceedings. The Duke Energy case, concerning a power project in Peru is an exception: “an investment dispute arising out of the imposition of taxes,” where the tribunal; found for the company, in part, because of the validity of a stability agreement.³⁷ Otherwise most of the case law cited seems to come from older cases about alleged expropriation (Cameron, 2006). One reason examples are difficult to come by is invoking the fiscal stability clause in an agreement is the “nuclear option.” Embarking on this path will lead to an irretrievable breakdown in relations between the host government and the contractors.³⁸ This is not an outcome that any party wants. This suggests that the real benefit of a fiscal stability clause may be to sow the seed of doubt in the host government that they might be invoked and thereby promote appropriate behavior.

E. Contract Renegotiation

Recent sources identify more than 30 countries that have revised their petroleum contracts or petroleum fiscal systems since 1999.³⁹ Wood Mackenzie (2008) identifies 28 countries where governments or national oil companies have changed terms for petroleum to increase their share of profits or government take. Most of these changes have occurred since oil prices began to rise again in 2002. The story is similar in the mining industry, though perhaps with fewer countries making changes.⁴⁰

In some of these cases, fiscal stability assurance were included in agreements—illustrating that they do not necessarily prevent renegotiation, or unilateral action by governments, when circumstances are perceived to have changed. Cameron (2009, forthcoming) points out, however, that the absence of a fiscal stability assurance may make arbitrators less willing to

³⁷ Duke Energy International Peru Investments No. 1 Ltd v Peru, ICSID Case No. ARB/03/28, IIC 30 (2006).

³⁸ See, for example, Louis T. Wells and Rafiq Ahmed, *Making Foreign Investment Safe: Property Rights and National Sovereignty*.

³⁹ Wood Mackenzie (2008), Quiroz (2008).

⁴⁰ At least eight cases are known to the authors, covering: Chile, DR Congo, Guinea, Liberia, Mongolia, Peru, Tanzania, and Zambia.

rule in favor of companies where they allege that a fiscal change represents a breach of previously made commitments.⁴¹

Contract renegotiation appears to have occurred mainly where fiscal regimes in place did not contain instruments that could respond with adequate adaptability and progressivity to changed circumstances. In recent years, of course, this has usually meant adaptation in favor of governments; in the 1990s, on the other hand, the required adaptability was often in the direction of granting benefits to investors.

The cases of changes of terms also include some where the manner of change was consistent with the government's prior commitment to investors who entered before the change. Once risk was perceived to be reduced, tougher terms were offered. One means for achieving this is by including items among the fiscal terms in the criteria for bids at licensing rounds. Angola, for example, in its deep water licensing rounds of recent years, has used both bidding for bonuses and a rate-of-return production sharing scheme that responds well to changes of circumstances.

F. Conclusion

Fiscal stability clauses are common and may reduce investor risk and create a more favourable investment climate and thereby ensure that the government receives a larger share of the rents from the natural resource project, all other things being equal. On the other hand, if companies accept fiscal risk, all other things equal, they may receive a larger share of the rents from the project. Fiscal stability clauses can be problematical, leading to disputes between the government and the contractor. They are not a panacea for a poorly designed fiscal regime or for weak governance.

It is not obvious that a fiscal stability assurance ultimately constrains a government when the protected terms become clearly untenable, whether by reason of changed economic circumstances, errors in regime design, or simply a change of political direction. Nevertheless, the "seed of doubt" that the assurance will be invoked may well preserve a fiscal regime applicable to a contract for longer than would otherwise have been the case.

Countries that want to include a fiscal stability clause in their mining and petroleum agreements may want to consider a time-limited provision that would cover the capital recovery rules, the income and withholding tax rates, royalty rates, and a maximum rate on import duties. However, any tax law change that affects businesses generally (e.g., a change in the thin capitalization rules) and that does not discriminate against the petroleum or mining sectors would apply. Companies would also be able to rely on non-discrimination provisions

⁴¹ Citing the 2007 ICSID award in *Parkerings-Compagniet AS v. Lithuania*, ICSID Case No. ARB/05/8, IIC 302 (2007), dispatched September 11, 2007.

and other protections in domestic law and investment and income tax treaties. The risk with such an alternative is that the “smokescreen” motivation comes into play.

A fiscal stability assurance, in the long run, is unlikely to be a substitute for a credible overall commitment by a government to maintenance of predictability in its fiscal regime. This predictability may not only mean fixed parameters, but also an anticipated process, or set of criteria, by which a government may modify a regime when circumstances require. The government’s ability to make such a commitment is affected by the public perception of the appropriateness of a fiscal regime for securing a reward to the state (on behalf of the population) as resource owner.

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