

ELEVENTH PLENARY MEETING OF THE POLICY DIALOGUE ON NATURAL RESOURCE-BASED DEVELOPMENT

12-13 December 2018

Summary Report

The meeting was conducted under Chatham House Rule: "When a meeting, or part thereof, is held under the Chatham House Rule, participants are free to use the information received, but neither the identity nor the affiliation of the speaker(s), nor that of any other participant, may be revealed."

I. Meeting objectives and structure

Under the co-chairmanship of Chile, Guinea, Nigeria, Norway, and the United Kingdom, 23 government delegations from Africa, Asia, Europe, Latin America and the Caribbean, as well as representatives from 8 partner international organisations and institutions, and 34 major firms, industry associations, civil society organisations, academia, law firms and think tanks, convened at the OECD on 12-13 December 2018 for the Eleventh Plenary Meeting of the Policy Dialogue on Natural Resource-based Development. International organisations and institutions represented included the Commonwealth Secretariat, the European Commission, the Extractive Industries Transparency Initiative (EITI), the Intergovernmental Forum on Mining, Minerals, Metals and Sustainable Development (IGF), the International Monetary Fund (IMF), the United Nations Environment Programme (UNEP) and the World Bank. Mr. Seong-ho Lee, Ambassador and Permanent Representative, Permanent Representation of the Republic of Korea to the OECD and Vice-Chair of the Governing Board of the Development Centre, and Mr. Federico Bonaglia, Deputy Director of the OECD Development Centre, delivered opening remarks.

The OECD Development Centre, acting as a neutral knowledge broker, contributed to framing the broad thematic areas and specific issues for discussion, as outlined in the background documents distributed to all participants in advance of the meeting. Besides the OECD Development Centre, the OECD Centre for Tax Policy and Administration, the Environment Directorate, the Directorate for Financial and Enterprise Affairs, the Development Co-operation Directorate, and the Directorate for Trade and Agriculture were also represented.

The two-day meeting brought together representatives of governments, international organisations, extractive industries, civil society, and think tanks and provided the opportunity to advance the work under the different Work Streams.

The first day (12 December) began with the presentation of a report by the OECD Development Centre under Work Stream 2, consolidating guidance on effective resource management and spending for sustainable development, followed by a session to review progress made on tackling BEPS challenges in the mining sector. The afternoon session offered the opportunity to share the finalised version of Guiding Principles VII and VIII of the Guiding Principles for Durable Extractive Contracts.

The second day (13 December) began with two sessions on the Thematic Dialogue on Commodity Trading Transparency, followed by a session to advance work under Work Stream 1 (Shared Value Creation and Local Development), with a thematic focus on upgrading and value addition in extractive value chains.

II. Summary of the Discussion and Conclusions

Throughout the course of a fruitful two-day meeting, participants commended the collaborative spirit, high quality analysis and inclusive partnerships underpinning the Policy Dialogue.

Under *Work Stream 1 – Shared value creation and local development*, participants recognised the importance of localising production and procurement of goods and services, for in-country value creation. As shown by the OECD TiVA database, services account for 23% of the value added in mining and 15% in oil and gas. In addition, the share of domestically procured services embodied in the exports of goods is between 16% and 19% in the mining sector, whereas in the oil and gas sector it is 12%. The percentage value of actual exports that are domestically procured services is substantial and has increased in the last 10 years, across countries, regardless of their income level. The collective assessment of industry's spending procurement strategies and categories of expenditures is essential to identify sizeable opportunities for localisation and value creation along the value chain, if the required local capability exists. For example, the analysis of spending expenditures of the oil and gas industry in Kazakhstan, conducted by private and public stakeholders, successfully informed the development of the Technology Roadmap and led to the establishment of a geochemical laboratory, using cutting-edge innovative technology such as fingerprinting, a cost-efficient solution for drilling wells. The laboratory is providing services to the oil and gas industry in Kazakhstan as well as to the wider region. South Africa has also undertaken a similar mapping exercise to reduce inefficiencies and develop innovative solutions in the mining sector to enhance competitiveness. Chile aims to become a global hub for clean mining technology and seeks to export value-added technological services worldwide, in order to diversify its economy. It also endeavours to establish a virtuous circle between investments, innovation and human capital by using its lithium reserves and unique geographical conditions to its strategic advantage. Innovative technologies for waterless iron ore processing show the transformational potential of sustainable solutions for upgrading extractive value chains. In light of the global climate action agenda and in anticipation of higher carbon pricing, creating a potential cost-challenge for large heavy industry emitters, innovative technological solutions for the decarbonisation of the iron and steel industries are being developed and tested. A country's potential to replace fossil fuels with clean energy, the falling cost of technology and government support are among the most important enabling factors for making decarbonisation happen. However, to achieve large-scale impact, an alignment needs to be achieved between climate, mining and local value-creation objectives and policies. This should be combined with the effective coordination between public and private investments in technology shifts necessary to support the development of climate-smart solutions and jobs. Development trajectories, targeting different sub-segments in the value-chain, differ across countries, according to context, variables and skill availability and require supporting regulation and financing instruments.

Participants validated the example from Kazakhstan, for inclusion in the *Compendium of Practices*. The *Compendium*, an online tool, helps operationalise the *Framework on Collaborative Strategies for In-Country Shared Value Creation*, and contains cases of practices that concretely illustrate how the *Framework's* guidance can be implemented by the private and public sector. The example discussed refers to STEP 3 and 4 of the Framework and showcases a successful technological services upgrade for the upstream oil value chain. In Kazakhstan, Shell procured and installed technology and trained staff for the creation of a geochemical laboratory. The ability of KazMunayGas to master the innovative technology and to use it for the benefit of the national and regional economy contributed to the effective implementation of this project. Meanwhile, Shell helped to translate its global experience into local solutions and continues to support the laboratory with data acquisition and interpretation. The laboratory is self-sustaining, financially stable and provides value-added services to the oil and gas sector as well as to other producing countries in the wider region. It improves field economics, through advanced technologies, by reducing the number of wells thereby leading to cost savings.

Under *Work Stream 2 – Revenue Management and Spending*, participants welcomed the presentation of practical guidance by the OECD Development Centre on how to translate finite natural resources into long-lasting development gains, and encouraged the OECD Development Centre to widely disseminate the results of the analysis and the practical policy recommendations. Participants highlighted the need to compare the rate of return on government borrowing against the rate of return on accumulated assets in a savings fund. Participants also stressed the importance of timing the establishment of a stabilisation fund and associated fiscal policy framework prior to the start of production. Moving forward, the Policy Dialogue will focus on mechanisms to catalyse extractive revenues to support the low-carbon transition.

Under *Work Stream 3 – Getting Better Deals*, participants welcomed the steps taken toward the finalisation of the Guiding Principles for Durable Extractive Contracts, following a Workshop that took place in conjunction with the Eleventh Plenary Meeting of the Policy Dialogue on Natural Resource-based Development. In terms of the consequences of non-fiscal changes of laws, participants agreed that the costs attributable to compliance with such legal and regulatory changes, wholly, necessarily and exclusively related to project specific operations, should be treated as any other project costs for the purposes of tax deductibility, and cost-recovery in production sharing contracts. If such changes in law and/or applicable regulations result in the investor's inability to perform his material obligations under the contract or if they lead to a material adverse change, that undermines the economic viability of the project, durable extractive contracts require the parties to engage in good faith discussions which might eventually lead the parties to agree to renegotiate the terms of the contract. Participants also agreed that a predictable fiscal regime that includes responsive terms defined in legislation and/or the contract to adjust the allocation of the overall financial benefits, between host governments and investors, to variables that affect project profitability (such as variance in commodity prices, costs, production volume, or resource quality) contributes to the long-term sustainability of extractive contracts and reduces the incentives for either party to seek renegotiation of terms. Participants further recognised the need for host governments to generate financial benefits from the extraction of their resources. Durable extractive contracts avoid sustained periods of commercial production with little or no revenue flows to the government.

Under *Work Stream 4 – Domestic Resource Mobilisation (tackling BEPS, corruption and commodity trading transparency)*, participants welcomed the practical progress made by the Thematic Dialogue on Commodity Trading Transparency in building blocks towards driving change. Participants acknowledged that the OECD Development Centre's preliminary *Stock-take of the Selection Procedures used by State-owned Enterprises to Select Buyers of Oil, Gas and Minerals* provides a useful knowledge base that helps to demystify the issues at stake, while also contributing to improving accountability. Participants reached common ground on the key types of information that are critical for accountability and therefore need to be included in the global reporting template for payment disclosure by companies involved in commodity trading. Besides data on physical transactions and financial flows, including the use of intermediaries, disclosure of corporate structure and beneficial ownership information and one-year time lag, participants recommended the inclusion of contextual information, such as commodity trading-related loans or guarantees given by the buyer to the government to better understand price information. Participants acknowledged the importance of knowing the identity of the parties involved in the transaction. It was noted that a database of state-owned enterprises managed by the OECD could help address the challenge that many buyers face in determining which entities are state-owned. Participants emphasised the importance of taking a holistic approach, linking commodity trading transparency with the broader international agenda on illicit financial flows, leveraging advanced information technology to collect and analyse data, and looking at potential interventions in both producing countries and trading hubs.

The IGF and the OECD Centre for Tax Policy and Administration presented three practice notes on how to address specific risks of tax base erosion and profit shifting in the mining sector: the valuation of mineral exports, excessive interest deductions, and tax incentives. Understanding the value of mineral production is critical for both revenue collection and contract negotiation purposes. Host governments should assess the level of risk of undervaluation, in order to determine the appropriate policy response. Available options range

from monitoring companies' own internal export valuation processes, requiring that these comply with international sampling and testing standards and demanding that companies report accordingly, through requiring the use of accredited third parties, to establishing a government mineral laboratory or a combination of the above. Using existing facilities in neighbouring countries or setting up a shared laboratory on a regional level reduce costs associated with establishing sampling and testing systems. Participants recognised that debt is a necessary part of the funding mix of capital-intensive mining projects. However, excessive interest deductions are one of the tax-planning strategies that can result in tax-avoidance. Profits can be shifted away from host countries to reduce taxable profits through the allocation of a disproportionately large amount of debt to the host country or the application of non-arm's length high interest rates for intra-group loans. BEPS Action 4 established a common approach to limit interest deductibility between 10% to 30% of EBITDA, with the option to combine this fixed ratio rule with a group ratio where groups are highly leveraged with third-party debt for non-tax reasons. This allows the deduction of an amount equivalent to their net third-party interest expenses, while also limiting the extent to which groups might be able to increase their intra-group interest deductions to exceed their actual net third-party interest expenses. Tax incentives also reduce the tax base. When governments consider offering tax incentives, they should not only appreciate whether they are necessary to attracting investment, but they should also weigh up their costs and benefits. A financial model is now available (<https://protect2.fireeye.com/url?k=9f05496f-c31e00e7-9f0562ac-002590f45c88-a86d8b1415c597f0&u=https://www.igfmining.org/wp-content/uploads/2018/12/IGF-Tax-Incentives-Model-beta-version-1.xlsx>) to policy makers and negotiators to help states better understand the impact of tax incentives, including investors' behavioural responses that can magnify the amplitude of the revenue loss. Experience shows that the more general and broad based the tax incentive, the less likely it is to produce development benefits. Further work is underway to understand how smart tax incentives can be linked to key performance indicators, such as job creation or local procurement, in order for governments to encourage desirable investor behaviour.

Work Stream 1 - Shared Value Creation and Local Development (Sessions 7-8)

Sessions 7 and 8 were chaired by Prof. Petter Nore, Senior Consultant at the Norwegian Agency for Development Cooperation. Session 7 featured a discussion on Upgrading and Value Addition in Extractive-Industries Value Chains. The discussion during Session 8 focused on the *Compendium of Practices*, a companion tool to the [Framework for Extractive Projects on Collaborative Strategies for In-Country Shared Value Creation](#).

Participants first discussed the opportunities for increasing the localisation of productive activities, supplying goods and services to the extractive sector, as developing resource-rich countries export mostly primary products with little or no value addition. Then, participants focused on opportunities for innovative solutions for upgrading extractive value chains for cleaner and more sustainable production.

Recognising the importance of localising production and procurement of goods and services, in order to create in-country value, new disaggregated data for the mining and oil and gas sectors from the OECD/WTO TiVA database show that services account for 23% of added value in mining and 15% in the oil and gas sector. In addition, a substantial share of services embodied in the exports of goods are procured domestically: 18% in mining and 12% in the oil and gas sector. Although the non-OECD coverage of the OECD/WTO TiVA database is limited to Brazil, Kazakhstan, Russian Federation, South Africa, and Vietnam, data show the share of services of exported products has increased over the last 10 years. Since services are less traded than goods, and rather domestically procured, there is a growing opportunity for resource-rich developing countries to look at upstream inputs for opportunities for value addition along extractive value chains. Collecting data on industry's spending procurement strategies and categories of expenditures is essential to the identification of sizeable opportunities for localisation and value creation along the value chain, if the required local capability exists. A new tool was presented called LION (Local

Investment Opportunities in Natural Resource Projects) that shows capital expenditure of the mining sector over time, informing policy makers and local suppliers about possibilities of increasing opportunities for local participation across different expenditure and procurement categories. It was reported that the tool was used in Ghana by UNECA in order to inform the development of the supply chain development programme. The Minerals Commission used this data to determine where the big chunks of expenditures are, how spending categories evolve over time and whether capacity exists within the country to take advantage of actual localisation opportunities. The resulting data were mapped against the list of 19 products that need to be sourced locally under existing local content requirements. As a result, it was found that the actual procurement and expenditure categories in the mining sector, and the government's perceived opportunities for local participation were not aligned. For example, by analysing the procurement expenditures in the gold and platinum sector, the South African Department of Trade and Industry (DTI) found that the Gold and Platinum industry procure 32 billion ZAR per annum worth of equipment, components, supplies of goods and services. In addition, there is large expenditure in key technology areas that can support the development of a dynamic domestic supplier industry. Recognising that the South African mining sector's competitive advantage no longer lies in easily accessible resources, or low labour and utility costs, the DTI will use the results of this analysis to leverage mining procurement strategies for the creation of demand for South African manufactured mining capital goods, consumables and services, with a view to reducing inefficiencies and developing innovative, competitive solutions in the mining sector. South Africa aims to enable collaborative partnerships in research and development; stimulate skills development and create Tier 1 and 2 suppliers within the value chain; and establish competitive local manufacturing capability to deliver the next generation of efficient mining systems to extend the life of gold mines to 2042 and platinum to 2045, while minimising social and environmental impacts. The manufacturing and mining industries are working together to come up with a shared method for the common description of products, as a necessary step toward the identification of localisation opportunities along the value chain. In Kazakhstan, the analysis of expenditures in the oil and gas industry successfully informed the development of the "Kazakhstan Upstream Oil and Gas Technology and R&D Roadmap" and led to the establishment of a geochemical laboratory for fingerprinting technology, a cost-efficient solution for drilling wells. The laboratory is providing services to the oil and gas industry in Kazakhstan as well as to the wider region. The case of Kazakhstan was validated by the Plenary for inclusion in the Compendium of Practices. A collaborative and coordinated approach between government, industry and research organisations was crucial to identifying opportunities for the localisation of value-added activities. The Roadmap process allowed all stakeholders involved to interact and develop a mutual understanding of existing technological challenges and potential solutions, providing guidance on possible areas for effective public-private collaboration. The development of value added technological services for the upstream oil value chain was prioritised for action. As a result, the Geochemical Centre of Excellence was established in Kazakhstan. Shell translated its global experience into local solutions, transferred the technology, financed the procurement of the new equipment, and trained local staff to master the new fingerprinting technology. After handing over the laboratory to KazMunayGas, Shell continues to support the laboratory by training local geochemists in data acquisition, processing and interpretation. It was emphasised that the partnership with KazMunayGas was vital to ensuring the sustainability of the project over time, and using the sophisticated technology to the benefit of the national and regional economy. For the past five years, the laboratory has been financially self-sufficient, serving the national oil company KazMunayGas and other operators as joint venture partners. Participants welcomed this Compendium example as a successful outcome of a proactive initiative involving government and private actors, supporting a cooperative and forward-looking approach to improving field production and development.

Participants further explored the transformational potential of sustainable solutions for upgrading extractive value-chains to simultaneously achieve climate change and local value-creation objectives. Participants learned about work that is underway at the World Bank to develop a Framework for Climate-Smart Mining, structured around the most impactful areas of engagement for climate and economic development impact : energy efficiency and the uptake of renewable energy, water conservation and

infrastructure, automation and transportation. It was observed that there is misalignment between industry's climate-resilient solutions and government policies on climate change. Moreover, public policies on climate change and local value creation are often disconnected. Such a disconnect can be explained by the lack of coordination within governments between mining and environment ministries, the lack of capacity to manufacture clean technology, the lack of financing to develop clean technology, and an unsupportive regulatory environment that favours existing technologies. At the two extremes of this wide spectrum, there are, on the one hand local content initiatives with little transformational impact and on the other hand, compliance programmes. In the middle, there are the potentially transformational green infrastructure projects that would not only enable productivity gains and enhanced competitiveness in the mining sector, but would also serve the needs of other sectors of the economy. In order for this to happen, it is necessary to progressively align the valuable initiatives undertaken by industry with the priority of transitioning natural resource-rich countries' economies towards a low-carbon future. In this context, participants heard two major technological breakthroughs for waterless and fossil-free iron ore processing. While the waterless technology was developed by a major mining company in Brazil, the fossil-free iron and steel making technology developed in Sweden is the result of a collaborative effort between the steel and iron industry to improve efficiency and reducing the sector's environmental footprint. A mining company, a steel maker and an energy provider created a joint venture called HYBRIT to develop and test a potentially viable technological solution for fossil-free steelmaking to achieve Sweden's objective of net zero emissions and of becoming a fossil-free economy by 2045. In order to meet climate objectives, industry needs to invest in technology shifts and often unproven technology. The Swedish government has launched the Green Industry Leap, a long-term initiative designed to prepare the domestic industry for the future. The point was made that a supportive regulatory environment, financial instruments, collaboration between government, industry, academia and civil society, abundant fossil-free electricity and specialised and innovative iron and steelmaking industry are all enabling factors for making decarbonisation happen. Chile provides another example of a strategic approach to using its lithium reserves to fund low-carbon technology research and development, such as electro mobility, as one example of lithium-based value added products, solar energy and low emission mining. Building on its strategic resources and geographical conditions, Chile has included a clause in its two exploration contracts with international companies exploiting lithium, to fund research and development over the next ten years, conducted by a consortium of universities, local firms and global companies. The aim is to move to an economic model with higher diversification and sophistication as well as environmental sustainability - locally and globally.

Work Stream 2 – Revenue Management and Spending (Session 1)

Session 1 was chaired by Mr. Javier Garcia, Counsellor (Environment, Energy, Transport and Development Cooperation) at the Permanent Delegation of Chile to the OECD. Participants welcomed the presentation of the OECD Development Centre's final report consolidating the main findings on how to translate volatile and finite natural resource revenues into effective and lasting development gains. They encouraged the OECD Development Centre to widely disseminate the results of the analysis as well as the practical policy recommendations. Resource revenues are characterised by their volatility and finite nature. The OECD/ATAF/AUC Revenue Statistics in Africa 2018 shows how the tax structure of natural resource-rich countries is evolving, with increased volatility of non-tax revenues compared to tax revenues. That is why budget stabilisation is an important component of the management and spending of natural resource revenues. With respect to revenue management, it would be sensible for resource-rich countries to put in place a stabilisation mechanism to ensure consistent and sustainable spending over time. Consistent revenues over time ensure that spending is continuous and effective. It is important that stabilisation funds are part of a consistent, comprehensive, well-designed, and country-specific policy framework that sets out rules for depositing resource revenues into the fund and when these funds can be withdrawn. Political commitment and bi-partisan support is indispensable to ensuring consistency over time for such a fund to deliver on its goals. In this context, participants identified Chile as a best practice example, in which there are fiscal rules in place for a balanced budget within a comprehensive and consistent fiscal policy framework to which

political parties are committed. Chile saves in times of high copper price and prepares its spending plans based on the copper price outlook and growth projections. This determines how much revenues the government would receive over time. When the price of copper declines, the stabilisation fund can be drawn upon to sustain spending. Like other financial institutions, the investment portfolio should be invested in low risk assets, and sound and informed investment decisions should be taken by expert professionals who understand risk management. Moreover, clear rules on transparency and disclosure are important to prevent corruption and create public trust.

The Session also addressed the question of how to spend and use natural resource revenues for sustainable development, focusing particularly on the trade-offs between spending now and spending later for future generations. Participants agreed that some sort of savings is needed to manage the volatility of natural resource revenues. However, the question remains whether a country should save for future generations, for thirty years down the line for example, or save enough to manage revenue volatility and provide stability over the commodity price cycle. In order to address the dilemma many countries are facing, the approach taken in the report takes into account the capital stock of the country, the level of development and the production time horizon of the country's natural resource revenues. For example, for Norway, which is a high-income developed welfare state with significant capital stock and a relatively short production horizon compared to other hydrocarbon producers, it makes sense to prioritise saving for future generations. On the other hand, in developing countries, where the capital stock is often non-existent or very low, human capital capabilities and infrastructure are underdeveloped, it makes sense to prioritise spending in order to improve development prospects. In Nigeria, for instance, which has a long-term production time horizon, it would be sensible to spend more now to ensure a more diversified environment over the next years, in which next generations can thrive. However, prioritising spending more now for development is not a licence to spend at random and as much as possible. Stability in spending is necessary, including paying attention to the absorptive capacity of the economy and the need to mitigate the Dutch disease. Nevertheless, stability by itself does not ensure effective spending. A stabilisation fund simply creates the environment in which sound public investment decisions are made. The question is how to focus natural resource revenues for development spending. Some countries have targeted expenditures for education or poverty reduction. Evidence shows that earmarking does not work, because it introduces further volatility into the system, with earmarked areas receiving too much funding when funds are abundant, and too little funding when commodity markets crash, if earmarking is done on revenues from production and not through a stabilised budget. Participants also highlighted the need to compare the rate at which a government is borrowing against the rate of return on accumulated assets in a savings fund. It makes little economic sense to save for future generations at low return, and then go to the capital markets to borrow at a high cost, thus increasing government debt. The one benefit that developing countries could derive from a savings fund is the permanent income from the financial returns that would flow in the future when production stops. A big pool of capital would be necessary to make this work. While stabilisation funds are useful tools to counter volatility in resource revenue in the short/medium term, long-term savings funds would not work in every context and, in particular, for developing countries that are borrowing at a high rates. Instead of choosing models or a given toolbox, developing countries should adopt sound principles for revenue management, address trade-offs before production starts and then consider which tools are appropriate for their specific macro-economic situation.

Evidence from the Policy Dialogues' previous report shows that earmarking revenues for specific public expenditure categories is not recommended. The case of Botswana was presented as an alternative to earmarking, in which there is no specific policy of earmarking but a consistent commitment to channelling revenues from natural resources effectively into non-recurrent spending areas, such as education and infrastructure, through the sustainable budget index. In developing countries, mechanisms that catalyse investments in new sectors, such as Strategic Investment Funds, can be useful for diversification, away from extractives. These funds are set up as co-investment platforms to attract financing for development.

Participants encouraged the Development Centre to widely disseminate the report and the practical policy recommendations contained therein. Moving forward the Policy Dialogue will focus on mechanisms to catalyse resource revenues to support the low-carbon transition in developing countries.

Work Stream 3 – Getting Better Deals (Session 3)

A Workshop on the Draft Guiding Principles for Durable Extractive Contracts took place in conjunction with the Eleventh Plenary Meeting of the Policy Dialogue on Natural Resource-based Development at the OECD. The Workshop was attended by representatives of government delegations, as well as representatives from partner international organisations, institutions and major firms, civil society organisations, academia, law firms and think tanks. The objective of the Workshop was to review the final written submissions received by the Secretariat and to collectively consider any proposed amendments. Participants in the Workshop were able to find common ground and reach a convergence of views on the drafting of Guiding Principles VII and VIII, and related commentaries. These principles were then presented by the Secretariat during Session 3 of the Plenary.

Guiding Principle VII recognises that regulatory regimes evolve over time, and addresses the implications that non-fiscal changes in law can have on extractive contracts and how the costs of compliance with these changes should be treated. When changes in law entail costs of compliance, these costs should be treated as any other project costs for the purposes of tax deductibility and cost recovery in production sharing contracts, provided that these costs are fully, exclusively and necessarily related to project specific operations. However, if such changes in law affect the performance of material obligations or undermine the economic viability of the project, durable extractive contracts require the parties to engage in good faith discussions, which might eventually lead the parties to agree to renegotiate the terms of the contract.

Guiding Principle VIII sets out a balanced approach to deal with fiscal changes in law, in particular to deal with the variance of economic factors, including: price, cost, quality/grade of the commodity, and volume of the resource. Participants noted that attempts to chase commodity prices are often the main driver behind renegotiations. Responsive fiscal terms can adjust automatically to meet fluctuations in commodity prices, cost, volumes and resource quality. Participants agreed that durable extractive contracts are underpinned by a fiscal system consistent with the governments' overall economic and fiscal objectives and that provides a fair share of financial benefits between the investor and the host government. Lastly, participants recalled the United Nations General Assembly Resolution on the Permanent Sovereignty of Natural Resources, and noted that sustained periods of commercial production with little or no revenue flows are detrimental to the durability of the contract.

The working group on the Guiding Principles will reconvene by teleconference between February and May 2019 to review any outstanding comments on the Preamble and Guiding Principles 1-6.

Work Stream 4 – Domestic Resource Mobilisation (Sessions 2, 5-6)

BEPS in Mining

Session 2 of the Eleventh Plenary Meeting provided an opportunity to learn about three recently published practice notes launched in October 2018 by the joint BEPS in Mining Program of the OECD's Centre for Tax Policy and Administration and the Intergovernmental Forum on Mining, Minerals, Metals and Sustainable Development (IGF). These provide policy and administrative guidance on how to address some specific causes of tax base erosion and profit shifting in the mining sector: excessive interest deductions, tax incentives and valuing mineral exports. The session also allowed for a demonstration of a newly developed financial model designed to help governments better understand the impacts of tax incentives in the mining sector. The model can be used to illustrate the potential costs of tax incentives, including how investors can magnify the intended tax benefits by changing their behaviour in response to a tax incentive.

Monitoring the value of mineral exports is a critical issue for governments as they need to understand the value of the minerals that are produced in their country for different purposes, such as contract negotiations, taxation and revenue collection. Participants considered the risks of under-valuation and noted the key factors to assess that risk and hence the impact on the level of revenues that governments can collect:

- What is the product? (different types of minerals can be produced from the same mine);
- What is the quality? (its form, grade etc.);
- How do governments calculate the sales revenues? Is there a benchmark price or a standard formula for valuation in contracts or revenue laws?; and
- Is the product mainly sold via related-party transactions or sold on the open market? (the more closely integrated the production and selling functions are, the higher risk of transfer pricing).
- Who is doing the valuation? Is there a requirement to go through independent testing or companies can use their in-house sampling and testing facilities? Which quality controls are implemented? Are companies required to comply with certain standards when they provide a value for their products? Do they have a self-interest in under-reporting the value of their production?

Participants heard the following key messages. It is often more important to invest in mineral sampling than the actual mineral testing, because most of the errors occur in the sampling process, whereas mineral testing is normally a rigorous process that is undertaken in accordance with various industry standards. The appropriate policy for export valuation depends on the level of risk of undervaluation. Not every policy response needs to be a full government run testing laboratory. These laboratories can be expensive to build and maintain and need to conform to global standards. There are alternative approaches to reducing risk of undervaluation, for example through the utilisation of independent testing. An independent testing company has a reputational interest in making sure that the results produced are of the highest quality. The more independence is in the system, the more the testing and sampling processes have to respond to the highest level of quality assurance, the less the risk of under-reporting and revenue losses. Such legal and policy requirements can go a long way in filling capacity gaps, without setting up a comprehensive testing facility in each country.

Participants noted the impact that excessive interest deductions in the mining sector can have on the governments' taxable base and considered measures to limit these effects. It was observed that excessive interest deductions are tax-planning strategies used by multinationals that can result in tax-avoidance. This problem is particularly prominent in the extractive industries. Mining is a capital intensive process. Consequently, mines are often developed with debt as a standard component of the funding mix, which is treated as a deductible cost, reducing the taxable profits where the activities take place. A tax planner may try to increase these reported costs in the form of deductible interests by inflating intra-group loans. For example, a multinational could set up a shell company or a fully-fledged treasury entity in a low tax jurisdiction. This would result in interest payments being deductible in the location where the mining activity actually takes place and income taxed at a low rate, or not taxed in the low tax jurisdiction. Profits can be shifted away from host countries to reduce taxable profits through the allocation of a disproportionately large amount of debt to the host country or the application of non-arm's length high interest rates for intra-group loans. Participants noted that many policy makers in resource-rich developing countries are aware of these tax-planning strategies but are struggling not only to identify complex corporate structures, but also to design tax measures that adequately address them, due to capacity constraints. In these circumstances, governments are encouraged to consider implementing a set of simple, clear and consistent measures in line with BEPS Action 4. BEPS Action 4 established a common approach to limit interest deductibility between 10% to 30% of EBIDTA, with the option to combine this fixed ratio rule with a group ratio where groups are highly leveraged with third-party debt for non-tax reasons. This allows the deduction of an amount equivalent to their net third-party interest expenses, while also limiting the extent to which groups might be able to increase their intra-group interest deductions to exceed their actual net third-party interest expenses.

Tax incentives also reduce the tax base and are dependent on governments' choice to use them to attract investment. When offering tax incentives, governments are advised to consider the actual costs associated with them, which consists of the cost of the tax incentives itself plus the cost of the behavioural response to that incentive by the investor which can magnify the amplitude of the immediate revenue loss. Participants considered the following key messages. Firstly, governments need to consider whether tax incentives are necessary to attracting investment in order to generate taxes, foster GDP growth, employment, spillovers, social development, technology transfer and whether the investment would happen anyway. Some participants considered that tax incentives are needed to reduce the risk involved and the sheer magnitude of investments at stake. Other participants observed that factors, such as macro-economic stability, the rule of law, the availability of physical infrastructure and skilled workforce affect investment decisions. While there are not many case studies on the performance of tax incentives and their impact on investment decisions, the point was made that in Nigeria, for example, there are 162 companies that have been granted tax holidays and which add very little to that country's GDP. It was recommended that governments should weigh the costs and benefits associated with tax incentives, factoring in the indirect costs associated with the behavioural responses of the investor, as well as the cost of administering an increasingly complex and fragmented tax system.

Participants discussed examples of how tax incentives offered by governments can trigger behavioural responses by investors. For example, if an investor is offered a 5-year (usually post-commercial production) tax holiday this represents a direct cost. However, it is likely that the investor will seek to speed up production in order to maximise the benefits of that tax holiday. Instead of mining all the ore at an equal rate, he may mine high-grade deposits first in order to take full advantage of the tax holiday. In fact, tax holidays create an incentive to shift as much profits as possible into the holiday period to benefit from zero taxes.

In order to assist governments to properly assess the impacts of various tax incentives, the Inter-governmental Forum on Mining Minerals and Metals (IGF) has created a *Financial Model*, which shows the direct costs of tax incentives and how these costs may change depending on investors' related behavioural responses, with the calculation in real time of the revenues generated before and after the application of the tax incentives. For example, for a 10 year tax holiday, the model shows that governments will no longer get income taxes, but only royalties on production. While revenues will go up because production will be shifted forward and royalties will be paid, by increasing the cut-off grade, the life of the mine will be shortened and consequently revenues will be lost. So, the actual costs of the tax holiday period could be twice as much the direct revenue loss. When offering exemptions from withholding tax on interests to foreign lenders, governments also need to understand that investors may try to increase the interest rates or the repayment period to maximise tax benefits. The *Model* is based on a medium-sized gold mine in sub-Saharan Africa but can be adapted to be used for other gold mines with different characteristics and other commodities, as well as projects of different scale. Governments will need to access relevant feasibility studies to get the underlying data information. The *Model* also takes into account discounting, and includes separate discount rates for the government and the investor, as they generally have different time horizons. Participants welcomed the presentation of the IGF model but noted that training may be required in order for officials from developing countries to be able to use the model to its full intent.

Participants welcomed the "deep dive support" programme that the OECD and the IGF are developing to provide a comprehensive review of the tax system in eligible mineral rich developing countries. These reviews will last 2.5 years for each country and the OECD/IGF is currently budgeted to complete reviews in four countries. In addition, the OECD operates a programme called "Tax Inspectors Without Borders" where experienced OECD tax auditors will go and work with their colleagues in developing countries. This is a demand driven process and it has been observed that the rate of return on this process is significant for the developing countries involved. Moving forward the joint OECD/IGF "BEPS in mining programme" will focus on fiscal stabilisation and will also seek to understand the impact of tax treaties on the mining sector, as well as dealing with metal streaming, hedging arrangements and ring fencing. The possibility to design smart tax incentives to encourage behavioural responses for the achievement of development benefits will also be explored.

Thematic Dialogue on Commodity Trading Transparency

Sessions 5 and 6 of the Eleventh Plenary Meeting were chaired by Dr. Timothy Okon, Special Adviser on Fiscal Strategy, Ministry of Petroleum Resources, Federal Republic of Nigeria; and Mr. Andrew Preston, Head of Joint Anti-Corruption Unit (JACU), Home Office, United Kingdom. The Thematic Dialogue on Commodity Trading Transparency was launched in June 2017, following commitments made at the London Anti-Corruption Summit to enhance transparency in commodity trading in order to fight corruption. In January 2018, the Thematic Dialogue made the case for action and identified three priority areas in which to make progress. Sessions 5 and 6 of the Eleventh Plenary Meeting provided an opportunity to advance the work under two of those priority areas: Output (1) the development of a global reporting template for payment disclosure by companies involved in commodity trading; and Output (3) the development of guidance to support SOEs in selecting buyers.

Participants noted that the task of improving transparency in commodity trading is a typical global collective action challenge that requires actions by governments, by commodity trading hubs, by companies, and by civil society organisations. It was recognised that the Policy Dialogue on Natural Resource-based Development provides a platform that allows all of those voices to be heard, and that this can help demystify many of the aspects of commodity trading that are not well understood in the public domain. It was further recognised that the Thematic Dialogue on Commodity Trading Transparency plays a vital role in contributing to a wider body of on-going work on related challenges, such as: illicit financial flows, beneficial ownership and transfer pricing. Participants were encouraged by the positive references to the work of the Thematic Dialogue on Commodity Trading Transparency in two recent publications: *The United Kingdom Anti-Corruption Strategy 2017-2022: Year 1 Update* and the *Swiss Federal Council Report: Swiss commodities sector: current situation and outlook*.

Session 5 provided an opportunity to continue the peer learning process on procedures and criteria used to select buyers of publicly owned oil, gas and minerals to build a collective knowledge-base to inform the development of Output 3: guidance to support SOEs in selecting buyers.

Research undertaken by the OECD Development Centre during the second half of 2018 demonstrated that there are several different methods of selecting buyers of publicly-owned oil, gas and mineral resources depending on what the country wants to achieve. Options include: spot-sales, term-arrangements (short, medium and long-term) and G2G transactions. Factors that can influence the process include: financing (resource-backed finance agreements); the procurement of products for the domestic market (commodity-for-product swap agreements); or the desire for a commercial relationship with a long-term end user.

The OECD Development Centre's analysis found that the majority of SOEs use spot sales, term sales or both to sell commodities. The weighting or reliance on one particular method can differ. For example, Ecopetrol uses spot sales for 58% of its sales. In Nigeria, NNPC and ENH use terms sales for the vast majority of their sales. The OECD Development Centre identified only limited examples of commodity-for-product swap agreements and resource-backed finance agreements, but did note that some SOEs use G2G transactions. Across the different sales arrangements, most SOEs used a competitive bidding process but did not necessarily do so on an exclusive basis.

All of the SOEs surveyed by the OECD Development Centre use some form of pre-qualification of potential buyers, which can provide a set of reliable buyers with an adequate standard of capability and can provide SOEs with more time to focus on the second part of the bid process, including the pricing/valuation of the commodity. In terms of the criteria itself, used to select buyers, three main components are ordinarily set out: financial, technical capability, and sometimes local content requirements.

- **Financial** – provides evidence of a line of credit from a reputable financial institution or demonstrate their ability to directly pay for commodities they wish to purchase.

- Technical – refinery, configuration, established trader, ability to hold long-term relationships, business model. GNPC also looks at HSE issues, SOMO (Iraq) places consideration on expansion into key markets and therefore will give priority to the Asian Market.
- Local content – local content requirements are intended to increase the participation of local entities in the commodities value chain. These requirements are especially prevalent for National Oil Companies in Africa. Participants cautioned that local content laws can put pressure on the selection process.

The OECD Development Centre also looked at who would be making that assessment and noted that the majority of the SOEs surveyed have permanent teams to administer the buyer selection process. Given the technical and commercial nature of the sales of oil, gas and minerals, multidisciplinary skills may be required: financial, commercial, technical, marketing, trading, due diligence, legal, procurement. The majority of SOEs have buyer selection teams comprised of their own staff, but some include representatives from central government agencies. Albpetrol in Albania is an example of this.

In respect of transparency, the OECD Development Centre found that the extent to which public information is available with regards to the buyer selection process differed widely across SOEs. For example, the policy/directive for sales is not ordinarily publicly available - PMI (Mexico) is exception to this. The disclosure of the buyer selection criteria is made available by around half the SOEs surveyed. Several SOEs surveyed make the identity of the buyer publicly available. Albpetrol and ENH go one-step further and also publish the identity of unsuccessful bidders.

Similarly, a wide variety of different practices across SOEs can be observed in the extent to which SOEs undertake additional checks on buyers (due diligence), as part of the buyer selection process. The OECD Development Centre sought to understand whether prospective buyers of commodities are required to declare general conflicts of interest, their beneficial ownership and any involvement of PEPs. Of the SOEs surveyed, around half require buyers to disclose general conflicts of interest and beneficial ownership, but only two required PEP declarations. Codelco was the only SOE that required all three declarations. SOEs also reported making additional due diligence checks on buyers – these may depend on the specific commodity (diamonds) or the identity of the buyer.

Lastly, the OECD Development Centre looked at pricing and asked whether SOEs had an (Official Sale Price) OSP or similar pricing formula or policy. In the Tenth Plenary Meeting, SOMO (Iraq) and NNPC both stressed that having an OSP is a key factor in order for states to capture full value in the transaction. The OECD Development Centre noted that almost all SOEs surveyed do have some form of OSP – often tied to an international benchmark (Brent, London Metal Exchange etc.) and then adjustment is made for the local conditions – grade of crude, transportation costs to market and other factors. Given the duration of some term sales agreements (UNIPPEC Jubilee deal in Ghana is 15.5 years), the OECD Development Centre looked at whether these agreements contain mechanisms that provide for prices to be reviewed on a regular basis in order to reflect market value. Around half of the SOEs surveyed utilise these adjustment mechanisms.

Participants noted that, unlike crude oil, the minerals and metals side of commodity trading has not been subject to the same amount of public attention in recent years. Direct sales transactions between government and traders are much less common than in oil and gas. In the mining sector, governments (and SOEs) have multiple ways to derive revenue:

- From tax;
- From holding ownership in production companies (whole or partial); and/or
- From receiving minerals as in-kind payments and then re-selling these minerals.

Receiving in-kind payment is much less common than in the oil and gas sector, however these payments can still be significant. For example, the national mining company of Azerbaijan received USD 33 million

of gold bullion as an in-kind payment. Participants recognised the data scarcity with respect to the buyer-selection process for sales of minerals and metals and noted that while the sales of minerals and metals are material and significant enough to warrant public disclosure, it is difficult to determine the exact scale of these sales.

Participants considered two examples of the buyer-selection process for sales of minerals and metals from Botswana (diamonds) and Chile (copper). In Botswana, the entity Debswana is a 50/50 joint venture between the government of Botswana and De Beers Group and represents 15% of the global volume of diamond sales in 2017. The sales process is governed by agreement between the government of Botswana and De Beers and sales occur roughly every five weeks. The valuation of diamonds is performed by a related company and then 50% of the diamonds are sold to the SOE, Okavango Diamond Company (ODC) who then re-sell them at auction. The proceeds from all sales are then divided in the following way: 22% taxes to the government, 10% royalties paid to the government, dividends are shared equally between the government of Botswana and De Beers Group. In the end, the government of Botswana's effective take is 80%. In Chile, the SOE Codelco is the largest copper producer in the world with 10% of global production. It sells both cathodes and copper concentrate, usually through a long-term sales agreement with long-term customers (e.g. BMW). Sales are negotiated annually with each buyer and pricing is determined annually based on market prices with the London Metal Exchange as a benchmark.

Participants also sought to gain a better understanding of the buyer selection process for the sales of natural gas and noted the unique role that Empresa Nacional de Hidrocarbonetos (ENH) plays in the natural gas sector in Mozambique, where ENH:

- Holds participating shares in all natural gas concessions;
- Assumes the role of “aggregator”, whereby ENH purchases gas from upstream producers and then re-sells that gas to downstream customer (25% is automatically allocated to the domestic market; and
- Collects royalty payment from the producer – in kind or in cash.

ENH uses open public tender to select the buyers of publicly-owned natural gas, and the evaluation criteria is set out clearly a terms of reference, available online. The terms of reference requests that bidders provide evidence of:

- their legal, fiscal and technical experience;
- the expected benefit to the country (economic, social, environmental);
- employment and training of locals;
- allocation and pricing of the final product into the domestic market;
- usage of local goods and services (local content);
- timing for implementation, required natural gas volumes, investment required, stability of project, and other relevant elements.

At ENH, an evaluation committee is formed to assess the bids received in the tender process. Once the Minister has approved the sale, the conclusions of the evaluation committee are made public. In respect of sales into the domestic market, the government will set a minimum price, but potential bidders must specify the price they will pay and this will be taken into account in the bidding evaluation. Regarding sales into the international market, ENH places a premium on the Asian market where there is greater opportunity of receiving higher prices.

Session 6 provided an opportunity to explore exactly which types of disclosure of information are necessary and useful in order to create an effective demand in accountability in resource-rich countries. This will inform the development of a global reporting template for payment disclosure by companies involved

in commodity trading. Participants noted the work that the EITI has done in this space and recognised the complementarities of the work of the EITI Working Group on Transparency in Commodity Trading with the Thematic Dialogue on Commodity Trading Transparency on payment disclosures in the commodities sector.

Participants discussed the importance of defining the rationale for why each type of information should be included in a global reporting template, why it should be disclosed, how it can improve accountability and how this contributes to the wider body of work on corruption and illicit financial flows. The conclusion was that, in general, complexity reduces transparency – so unnecessary complexity should be avoided where possible. The same can be said of the areas in the sales process where discretion is exercised, as this can cause confusion and erode transparency.

Participants considered the proposed types of information to be disclosed in two categories: the physical commodity trade; and the financial flows. They noted the need for increased transparency as it directly affects the value of the resource realised by the government. Similarly, typical crude oil transactions are very large, and consequently, altering any aspect of this can result in significant value change. In addition to the price per unit of the commodity, it is also important to disclose and to understand all of the fees, charges and credits, as these can also affect the final value. All these amounts need to be recorded accurately and participants agreed that robust and tested industry standards can assist governments in the categorisation and recording of these key pieces of information.

The foreign exchange rate conversion process should be clearly described in contract so there is no opportunity for confusion or manipulation, although it should be noted that the majority of global sales of crude oil take place using United States Dollars. Participants noted some potential challenges with some of the proposed types of information that are set out in the two categories, primarily related to how data is recorded in companies' systems. For example, the contract/invoice number is often recorded differently by the buyer and the seller, the payment receipt date may not be consistent between the buyer and seller – and may need to be disclosed by the seller.

Participants considered the role of intermediaries in the trade of publicly-owned commodities and noted how greater corporate structure and beneficial ownership disclosure could help alleviate the issues associated with intermediaries and ensure that value is not lost in transactions. Participants recognised that intermediaries are quite prevalent in the commodity trading sector and obtaining information from them is challenging. Furthermore, these entities (intermediaries, briefcase or shell companies) often exist within complex corporate and legal structures, including, for example, joint ventures with politically exposed persons (PEPs).

Participants welcomed the recent steps taken by NNPC in Nigeria to reduce the involvement of intermediaries in the buyer selection process. NNPC has a list of approved buyers that is publicly available and can be scrutinised to check the capability of these potential buyers. NNPC now awards term contracts to local companies so the need to undertake sufficient checks for beneficial ownership and PEPs is heightened. Participants noted that there are different definitions of beneficial ownership and PEPs, and that a sufficient assessment of a beneficial ownership disclosure requires a significant amount of information. Participants cautioned that the disclosure of just a name is not enough, as other aspects, including direct or indirect, means of control, will need to be assessed also.

Participants considered a recent example from Ghana where crude oil was being sold to Litasco from the TEN field at a discount, whereas oil from the Jubilee field was sold to other buyers at a premium. The rationale for Litasco negotiating the TEN crude at a discount was because Litasco gave support to the government of Ghana through a number of separate deals, including: providing fuel for power generation, cash guarantees and the provision of a loan of USD 100 million. If interested stakeholders viewed the financial data disclosures for the sale of crude oil from the TEN field, this would not shed light on the additional deals that were linked to the price per barrel that Litasco ultimately paid for the TEN crude. Consequently, participants considered whether a third category of information should be included in the development of the global reporting template on “other engagements a trading company has with a

government”. In order to achieve meaningful accountability on commodity sales, participants should not just focus on sale of the commodity but consider the *entire* transaction with the trading company.

Participants acknowledged that it can be difficult for trading companies to determine if the seller they are dealing with is a state-owned enterprise (SOE), despite undertaking an extensive and resource intensive due diligence process. This is especially prevalent when dealing with Chinese SOEs for which there is very little public information available in English. One example was a Chinese public university that had purchased an aluminium smelter that was seeking to sell commodities on the market. Participants discussed how a global database of SOEs and their subsidiaries, hosted by the OECD, could assist trading companies in their due diligence efforts to correctly identify when they are engaging with state-owned entities. The OECD has extensive in-house expertise in the field of SOE governance through its Corporate Affairs Division of the Directorate for Financial Affairs and Enterprise. The 2015 OECD *Guidelines on Corporate Governance of State-Owned Enterprises* contains a definition of SOEs that trading companies can use for this purpose and the OECD will consider the opportunity to establish the SOE database as an additional output of the Thematic Dialogue.

Participants considered the time lag that should apply to payment disclosures, and recalled that at the Tenth Plenary Meeting in June a time lag of one year was proposed as a reasonable timeframe for trading companies to meet without affecting their competitiveness. Lastly, participants discussed recent technological advancements and how these could be used for accuracy, access and analysis of the commodity trading data. These may include Blockchain, artificial intelligence, as well as the use of targeted financial econometrics.