Future tax and fiscal obligations, such as royalties to state authorities, are critical in making shale gas exploration investment decisions. Such investments are massive and are potentially worth billions of dollars, if they lead to production development.

They are also high risk due to uncontrollable reasons such as geology, technical and economic conditions. Quite often the returns on investment can be expected to start only after many years and it could take a long time before they break even. To minimise investment risks and to offer the best prospective return for their shareholders, companies look for government commitments that will give them the best deal: the lowest possible tax obligation. Governments, on the other hand, are under pressure to maximise the financial benefits for the society as a whole, which tips the balance towards the highest tax rate possible.
Therefore shale gas companies' financial interests are directly opposite to their host governments. At the same time both companies and governments have an overriding common interest: if governments want to maximise their tax income from future shale gas production they have to ensure that developments will come to fruition and be managed efficiently. This can only be achieved by involving the private sector on a competitive basis. The conundrum is setting for a "win-win" deal for both parties based on the common interest of companies and governments. It is vital in the long-term that they understand their respective positions and are able to negotiate in good faith.

The High Tax, Low Tax Dilemma

There are two main functions of tax in a democratic state. The first is to provide for public goods and services such as defence, education and healthcare. The second function of taxes is the redistribution of wealth.
As different democratic countries have different traditions and are in different economic situations, the level of taxation and the range of services provided by a state can vary enormously. Generally speaking, the US can be regarded as preferring a "small state": i.e. a low level of taxation and minimum level of services provided by the state. By contrast, Scandinavian countries generally have a tradition of high taxation rates to pay for comprehensive state provisions: services from cradle to grave. Many European countries hold the middle ground, which results in pressure for low taxes whilst at the same time maintaining a high level of services provided for by the state.
A major complication then occurs as these arguments are only partly true when applied to the taxation on the extraction of natural resources. Whilst the exploitation of natural resources is the result of a lot of value created by individuals or private enterprises through inventing and applying technology and operational activities, the underlying value lies in a

resource itself: the oil, gas or other minerals extracted. Therefore the first consideration in the taxation of exploration and production of shale gas is not about the value created by individuals or private businesses through their work, initiative or innovation but rather who owns the exploited resource.

There are very few democratic countries such as the US where natural resources belong to the individuals who own the land (mineral rights). In these countries the financial gain for the resource is a private matter between the owner and the exploration and production company. In such cases the issue of taxation is a “simple” issue of general taxation.

In almost all democratic countries, especially in Europe, mineral rights belong to the society (embodied in the state). In such cases taxation on the production of natural resources becomes a very sensitive issue of sharing with the society what is rightfully theirs: the value of the resources being produced by companies. However, as it is practically impossible to untangle and apportion financially the value of the resource from the value added by the producers who extract it, the taxation on production of natural resources is very complex and adversarial by its nature. Producers naturally focus on the value they add and the huge financial risk they take in their activities to proceed with production. This supports the argument for low levels of taxation. Yet, the public and local communities look more at the value of natural resources which “belong to them”; which is a profound argument for high taxation.

From their own standpoints both are right. The question is therefore about balance.

Local Communities: Getting a Fair Share

In countries where mineral rights belong to local communities and the wider society, people consider natural resources, such as oil and gas, as their own. This can result in a real anti-private enterprise effect. It is quite perverse as the focus is then not so much on how much profit the local communities and the state can get from these natural resources but how not to feel exploited. This means minimising the profits of any private enterprises that extract natural resources. In many European countries, especially in Central and Eastern Europe, this attitude is enshrined by decades of an economic system where state-owned or state-controlled companies almost exclusively explored and produced natural resources. In such an arrangement the issue of private profits either does not exist (in the case of full state ownership) or does not come to the fore and is under state control (in the case of state control of companies). As the state owns licenses, any license awarded is a transfer from one state controlled entity (a ministry or a licensing authority) to another (a state-controlled

natural resources companies).
State controlled natural resources companies were considered by local communities as a part of state activities. Areas which experienced natural resources exploration and production, such as Silesia (hard coal), Bełchatów (lignite), Lower Silesia (copper), the Carpathian mountains (gas and oil), benefited from overall economic growth, jobs and general industry involvement with communities through the sponsorship of sports and cultural events. For local communities and the public at large there was no issue of private investors benefiting from natural resources and any excess profit went to the state.
State control of the natural resources industry has led to a current predicament. There is a lack of understanding in former nationalised economies that private investors take considerable risk when making investments and that they expect a return on such investment (otherwise shareholders would not approve of the investment) and that it is likely to take a long time for a private company to achieve any return. Such considerations put private investors in a very difficult position with respect to local communities and the general public in many European countries.
The root cause is an asymmetry of information. The negative effect of asymmetry of information is magnified by the asymmetry of means; i.e. large private companies have far better access to trusted expert advice and, in the case of a dispute, far better access to legal advice.
Private companies hold the opposite, yet justified, interests to the state, combined with these asymmetries, and this results in a trust gap. Such a gap is not conducive to building relationships based on “win-win” strategies or agreeing compromises. The weaker party in such a relationship – in this case local communities and many from the general public – will always feel they have been taken for granted, no matter how good the deal. This is because there will be no way for the weaker party to verify the position of the industry.
However we must not lose sight of the fact that behind this conundrum is the fact that local communities, and the public, want a fair share of the benefits of natural resources. Therefore the key is to build relationships based on trust by reducing the asymmetries in relationships, develop strategies for local involvement that have practical effects (jobs, education, supporting sports, and cultural events). It is not about hand-outs, instead credibility is the means for industry to build mutually beneficial relationships with local communities.

Private Investors: Towards a Good Profit

Companies and investors are chasing profits and returns. Indeed, it is a duty of those heading-up companies to maximise their profits. Quite often the general public takes a negative view on this which can turn into an emotive political issue. In some countries, such those in Central and Eastern Europe, the public often do not realise this. All too often profit chasing, especially by well known individuals and corporations, is considered as sheer greed. There is another interpretation of profits, they spur economic growth, raise living standards and boost the welfare state and pensions. If there were no profits there would be no taxes. Furthermore, most often the investors and shareholders in an exploration company are ordinary pensioners or savers through their pension, mutuality funds or directly.

However the duty of maximising profits sometimes leads to behaviour by companies that at best can be morally dubious. Even legitimate tax optimisation can create a perception of being unethical. The international oil and gas industry is an inherently risky business, and with a lot of money at stake. Therefore private companies are very tempted to optimise their tax position.

The negative perception can obscure the basic fact that investors and companies have to take a substantial up-front risk and will gain returns on only a small proportion of investment projects. This proportion can be staggering, with a 1 in 5 or even a 1 in 10 success to failure ratio. This means that many exploration projects are abandoned. The costs of failures have to be covered by those few projects that succeed. It is not a lottery but it is a serious calculated risk.

Local communities and the general public only see the developments that succeed and deliver substantial returns. As companies do not publicise the projects that did not work out, it is not widely understood that the profits are risk factored, i.e. that they have to cover the investments that resulted in losses.

This is a highly toxic situation in terms of public relations. Tax optimisation is seen by the local communities and general public through the lens of staggering profits of successful investments. They will not see that these successes are part of a much larger portfolio of projects, most of which are sunk costs from a financial perspective. In democratic countries with 24 hour news and social media, this creates a significant risk that the general public will turn against the private businesses involved.

This can be the first step on a downward spiral. The negative attitude of the general public increases the medium and long-term risk for private companies (e.g. that governments introduce populist rules that would have an adverse impact on investments) which results in companies prepared to pay less of their profits in taxes or they decide to leave. Lower tax payments, in turn, result in the increased perception of exploitation by the companies, which further increases negative attitudes towards the industry in the general public. This further increases the medium and long term risk for private companies, and so on.

Ultimately this downward spiral may result in companies abandoning private investments altogether. But even if they decide to remain, both sides are on a losing side: private companies operate in a higher risk environment than otherwise they would have and governments, on the other side, collect less in taxes than they could have. This is a classic "lose-lose" situation, where there is increased risk due to lack of long-term stability and understanding.

If we consider that, in financial terms, so-called "above ground risks" constitute around 80% of all risks in the oil and gas investment cycle (as estimated by Goldman Sachs), this is a massive long term business planning issue not just an academic consideration. "Above ground risks" are, by and large, a pure waste that should be removed or minimised whenever possible.

Negotiating a "Win-Win" Deal

Historically the inherently adversarial relationship of sharing the wealth of oil and gas resources between private companies and the host states has resulted in far from optimal arrangements for wealth creation and transparent governance.

Typically state monopolies were a result of either the existing economic system dominated by state-owned or controlled companies in strategic industries (like in Central and Eastern Europe) or due to the nationalisation of private companies. The latter, nationalisation, resulted in shareholder losses and the conclusion that long-term risks can be enormous. The increased long-term risks perception created an expectation of higher returns in the short term in order to cover for the increased risk. All too often this led to exploitative practices, typically fuelled by corruption in order to extend the "short term" for as long as possible to maximise benefits. In the most extreme cases the outcome has been failed states.

This looks like a "devil's alternative" between state monopolies and exploitation by private companies. State monopolies are inefficient and unproductive in dealing with significant natural resource developments. This results in "Dutch disease" where state monopolies spread a lot of "free money" in the economy thereby making other industries uncompetitive. Exploitation by private companies leads to more acute cases of a "resource curse".

There is a solution. Countries, such as Norway, Canada, Australia and the UK, have shown that oil and gas can be a business that contributes to the wealth of the host nation, stimulates the economy, as well as providing private investors with a very healthy return in the long-term.

First, a competitive environment must be created and the industry must operate according to free market rules. There can only be very few exceptions from this rule as any exception is an anomaly with potentially far reaching consequences. Such exceptions must be justified by strategic, state security, public safety, etc. issues. This approach cannot be limited to operators and must apply across the entire industry, including service providers.

Competition stimulates innovation, technological development and operational efficiency. They, in turn, drive productivity up, drive down costs and lead to maximum returns. This results in the maximum wealth that can be shared between private investors and the state through tax.

Second, the industry has to be transparent and under the control of democratically elected local and central governments. Arguably, nothing is more damaging to the industry's interests than a public perception that there are important issues, such as disclosed profits or health and safety, that are hidden from scrutiny.

Pressure groups and NGOs play a very important role in scrutinising the transparency of the industry and add to the credibility of democratic control. In this day and age of 24 hour news and social media complete scrutiny is inevitable. Openness, with additional and adversarial checks and balances only add to credibility.

Third, education plays a key role. Understanding the issues of long-term risk, diversification of investment and planning in business is not trivial for ordinary people. Indeed, it can help by showing parallels with the countries and developments where the natural resources industry has become a success story, emphasising the key factors of transparency and democratic control. In addition, showing the contribution of the industry to national wealth in many forms through taxation, job creation, education, technological developments, sponsorship of sporting and cultural events is also a key part of the education process.

Fourth, the governments must structure their relationship with the industry in a way that will highlight long-term commitment. This is not only about laws and regulations, as they can easily be changed from friendly to hostile. It is more about building a *local* industry dependent on the exploration and production of natural resources.

Competition, lowering barriers of entry for newcomers and a free market approach is a starting point for a “win-win” arrangement. If a large part of the economy, a significant number of jobs and local economic activities of ordinary people depend on the natural resources industry it will create the best long-term assurance for private investors that the host government will work hard to assure the success of the industry. In the same way as private investors are held hostage to host governments and the general public, this will also make the governments and general public dependent on the industry and its success. This interdependency is the key to minimising the long term-risks of the private investors.

Transparency, democratic control, education and mutual interdependency for the success of the industry would build trust between the industry and general public. Such trust will minimise overall long-term risks for private investors. As a result, the industry will be prepared to pay more in taxes than otherwise. The payment of higher taxes further increases the dependency of the state, the general public and the local communities on the profits of the industry. In the case of adverse economic conditions the state is very likely to adjust by lowering taxes or providing other incentives in order to help the industry. This works like an insurance policy to minimise further the long-term risk of the industry.

This is not a theory. This is what has happened in Norway and the UK where taxes on oil and gas production have always been high but, despite very risky offshore operating conditions, the industry developed spectacularly. When the North Sea bonanza started to

subside over a decade ago the fiscal arrangements were adjusted accordingly to reflect the new conditions.
Taxation on the profits of the natural resources industry can become a form of insurance policy to minimise long-term investment risks. This is a "win-win" arrangement between private investors and governments. In the presence of relatively lower risks private investors are prepared to accept lower returns and higher taxes. These higher taxes contribute to the society making it more dependent on the industry. This balance should ensure long-term sustainable development resulting in long-term benefits for private investors as well as the society as a whole.
Undoubtedly the route to a "win-win" arrangement between industry and the states is not easy. It is an ongoing negotiating process which must be based on trust and a real understanding of each other's position. Both parties must be on the same footing. It requires the support of both private investors as well as the public at large. But, as the examples of Norway and the UK show, the outcome can be quite a spectacular "win-win".

Source: Shale Gas Europe. Read more…