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New oil tax laws still lack balance

Andrei Konoplyanik says the tax reforms made this month discourage investment

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On January 1, 2002, a new tax system took effect in Russia for producers of mineral resources. The profits tax rate has been reduced and a new tax on mineral resources production introduced to replace several taxes subsoil users used to pay.
This completes the first stage of Russia's planned tax reform. Changes made so far only involve those working under the general licence system.
Work on a special chapter of the Tax Code devoted to taxation under PSAs continues.
Oil & Capital joined forces with the Energy and Investment Policy and Project Financing Foundation's tax specialists to analyse the changes and draw conclusions.

Our preliminary conclusion shows that tax reform in the oil industry has not been properly balanced at the current stage.
The introduction of the tax on mineral resources production and the review of the profits tax, on the whole, discourage investment and only serve as the means for resolving the state's fiscal problems. The main target is getting as much as possible in tax revenues from producers of mineral resources to have a budget surplus required, first and foremost, to finance social expenditures (wages, pensions etc) and to be able to make unprecedented high payments on Russia's foreign debts in 2003.
At its current stage, the tax reform does not encourage producers to increase the efficiency of production of all categories of reserves. It rather prompts them to partially extract them at easily accessible fields.
Rather than growing more efficient, the tax system has become more primitive.

The reform has failed to make the tax system both more transparent and effective. Transparency has prevailed over efficiency.
Only oil companies seeking to maximise their current financial flows and exports while minimising investment activities can benefit from the introduction of those new tax instruments.
Under those conditions, the introduction of any mechanism of the tax on extra revenue (the third element in the 'new' tax system for the oil industry) can only further discourage investment.
As competition in the world markets of oil and capital has been toughening, potential strategic investors' interest in Russia's oil and gas may further flag and borrowings by Russian oil companies to finance their oil and gas projects in the country may grow more expensive.

As a result, the tax reform of this kind may lead to Russia's losing its competitive positions in the world oil and capital markets, and liquid fuel may even lose its ability to compete in the domestic market of energy and production resources.
To avoid that, tax reform should have a complex nature, ensuring a balance of the state's fiscal and investment interests. Striking the balance of interests at the macroeconomic level should be the main objective for the state when it works up and pursues an effective economic policy.
It has been commonly accepted that Russia's tax system for the oil industry was inflexible, too complicated and fiscally oriented which prompted the attempts to perfect it and bring it in line with Russia's Energy Strategy until 2020. It three main components: the profits tax, the tax on

the production of mineral resources and the tax on extra revenue.

The former two elements in this three-tier tax system were introduced on January 1.
Work of the draft law on the extra revenue tax — it will let the state withdraw part of differentiated rent or super profits gained by mineral producers due to their work in better natural conditions — continues.
Under the general subsoil use licensing system, this tax regime will be governed by administrative law, with all three taxes unilaterally fixed by the state.
Under PSAs based on contract law, the tax on extra revenue will be replaced by production sharing established through negotiations.

The profits tax
The new procedure for the profits tax is established by Chapter 25 of Russia's Tax Code.
The main innovation is the reduction of the profits tax rate from 35 to 24 per cent, while all its tax breaks have been withdrawn, including investment allowances (companies were allowed to reduce the tax base for the profits tax by up to 50 per cent, if the money was used for investment).
The shares of the profits tax going to the federal and local budgets have been reviewed.
Until now, 11 per cent of the 35 per cent went to the federal budget, 5 per cent to the local budget and 19 per cent to the regional budget (and the region could offer a tax rebate within its share by up to five percentage points).

The 24 per cent profits tax will now be divided differently — 7.5 per cent to the federal budget, two per cent to the local budget and 14.5 per cent to the regional budget, with the latter allowed to grant a tax break up to four percentage points, which may bring the actual profits tax rate down to 20 per cent.
The cabinet and many parliament members regard the reduction of the profits tax rate as a strong incentive for investment.

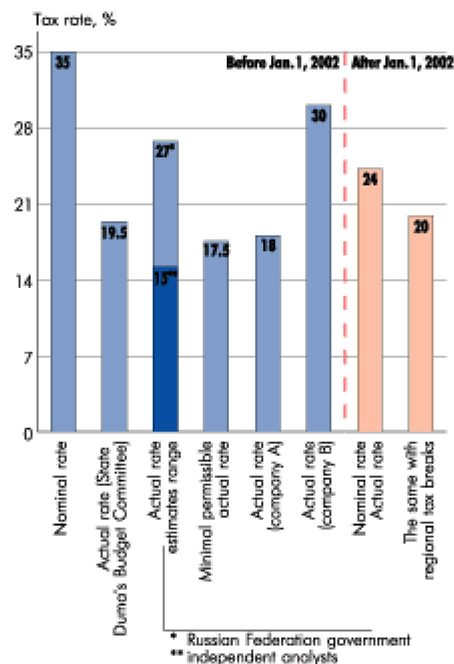


Fig. 1
The profits tax: nominal and actual tax rates before and after January 1, 2002

It is worth mentioning some potential consequences of this innovation for investors in oil and gas projects.
Profits tax breaks, primarily investment allowances, have been broadly applied in Russia. According to the State Duma's budget committee, the actual profits tax rate (with account of all tax breaks) was 19.5 per cent for Russia on average in 2000.
When the Tax Code's Chapter 25 was debated, government officials estimated the actual rate at 27 per cent, while independent analysts assessed it at between 15 and 17 per cent **(see Fig. 1)**.

In the opinion of some analysts, the withdrawal of investment allowances, given the new profits tax rate of 24 per cent, will keep actual rates virtually unchanged as regional tax breaks have been retained. Therefore, if regions grant tax rebates, the actual profits tax rate will be almost the same — 19.5 per cent compared with the previous rate of 20 per cent.
But that is not too accurate.
Various companies have not enjoyed similar investment allowances. Smaller and mid-sized (non-integrated) companies have been particularly keen on using them.
On the one hand, those companies only have one product and, therefore, depend on oil price

fluctuations much more than vertically integrated oil companies.

On the other, as a rule, they work at smaller and mid-sized fields with hard-to-recover reserves and get their share of economic rent through specialisation, which requires more expensive technologies.
For that reason, the ratio of annual capital investment to production volumes is higher for smaller and mid-sized companies, than for vertically integrated companies — by 1.5 times in 1999 and 5.5 times in 2000, according to AssoNeft, an association of smaller and mid-sized companies, the Afina club, and the Central Throughput Board.
This explains why smaller and mid-sized companies have used investment allowances to the utmost and their loss will be particularly painful for them.
So, to a company having long-term production plans, maximising its oil-related priorities, and implementing its investment programme to expand its production capacities etc, which used to pay an actual profits tax rate of, say, 18 per cent (company A on **Fig. 1**), the tax reform means an effective growth in the tax burden.

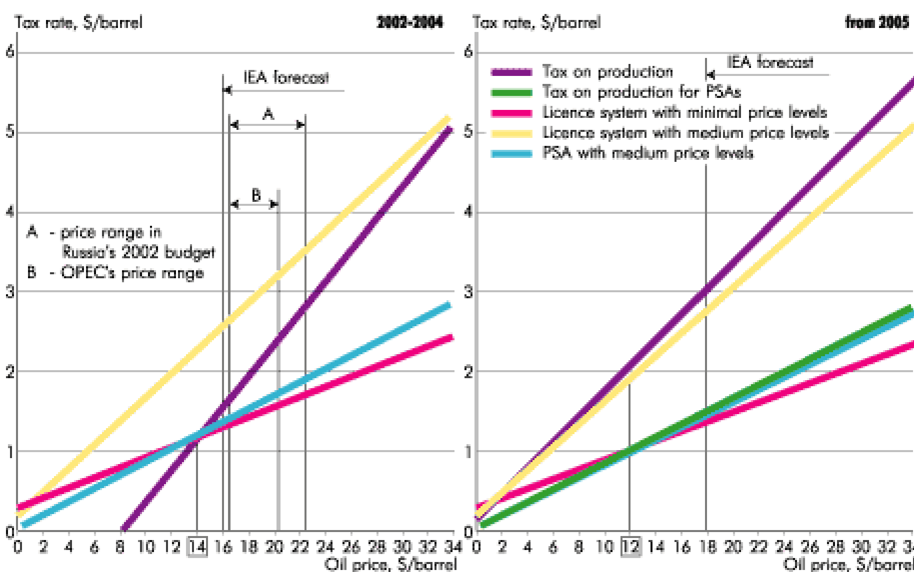
But vertically integrated oil companies maximising their current financial flows, continuing to 'eat away' available reserves on their balance sheets, which they got (like any other Russian vertically integrated company) mostly for free in the early 1990s, for which the actual profits tax rate was, for example, around 30 per cent (company B on **Fig.1**), will see their tax burden eased due to the reform.
The reason is that the vertically integrated company focuses on its short-term financial priorities in a broader range of its businesses and does not necessarily intend to go on working in the sector in the longer run.
Rather than laying the foundation for future production, such a company is interested in increasing its current capitalisation, using all possible means to add as many reserves as possible to its balance sheets, for its owners to be able to sell the business profitably.

Therefore, for companies engaging in a lot of investment activities, the reduction of the nominal profits tax rate in exchange for a repeal of investment allowances means an actual growth of the tax burden, even if they can get regional breaks for the profits tax.
The reduction of the nominal profits tax rate cannot encourage foreign investors either, if their home countries are parties to agreements with Russia on avoiding double taxation. The amounts by which their profits tax is reduced in Russia will be charged by tax agencies in their home country.
In this respect, the law may be regarded partially as a measure strengthening Russian companies' ability to compete with foreigners in the Russian market, even as the tax burden on oil producers grows. But it certainly cannot improve the Russian oil industry's competitive edge in the international market.
In my opinion, the new profits tax will discourage investment and its reform is only aimed at satisfying the state's purely fiscal interests.

Tax on production
The tax on mineral resources production replaces royalties, payments for the restoration of the mineral resources base and excises (except excises for natural gas). The new tax and its levy procedure are outlined in the Tax Code's Chapter 26.
According to Russia's Ministry of Finance, the tax on production is introduced as a mechanism that would ensure a tax burden equivalent to the taxes it replaces. This way the Ministry of Finance fixed the basic tax rate at 16.5 per cent of gross revenue — 8, 6 and 2.5 per cent are the actual rates for royalties, mineral resources payments and excises (based on the weighted average prices of oil supplied to the domestic market and exported).

True, the rate of 16.5 per cent will only be applied in the future, starting in 2005. For PSA projects, half the rate will be used (it has not been specified, whether or not the reduced rate will be effective between 2002 and 2004). For projects implemented under the general licence system with companies financing geological exploration with their own funds, the tax rate will be 30 per cent lower than the basic rate of the tax on production.
Between 2002 and 2004, a special rate of the tax on production will be levied, equal to 340 roubles per tonne, adjusted to the rouble's hard currency rate (against the dollar) and changes in world prices of Russia's Urals export blend.
At this initial stage, the tax on production will serve as a means of combating transfer prices. For that reason, a specific rate is fixed, rather than an ad valorem rate.
For hydrocarbons, tax revenues are shared 80:20 between the federal budget and the budget of a relevant region, and for complex regions (where hydrocarbons are produced in an autonomous district within a region), the federal budget gets 74.5 per cent, the autonomous district, 20 per cent, and 5.5 per cent goes to the region.

Fig. 2
The tax on mineral resources production and taxes it replaces compared (estimated for a case when 100 per cent of produced oil is exported)

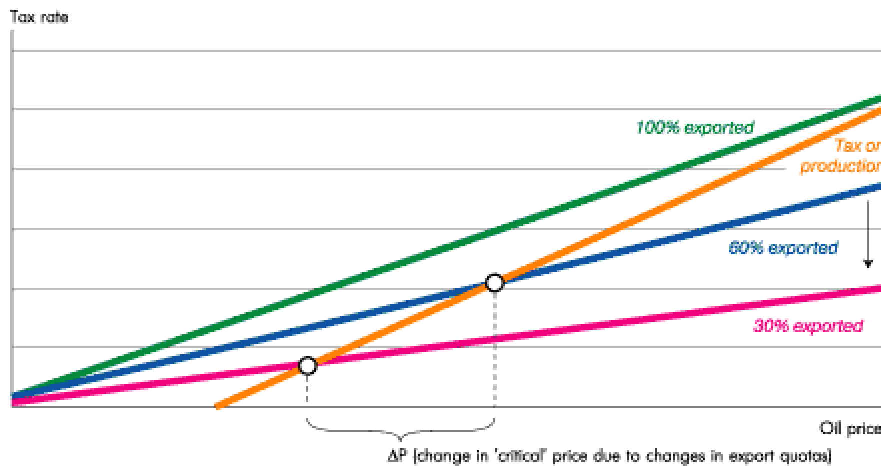


For production on Russia's continental shelf or in its exclusive economic zone, 100 per cent of the tax goes to the federal budget.
As seen on **Fig. 2**, the introduction of the 'specific' rate for the tax on production eases the tax burden on fields developed under the general licence system virtually for any price level (prices higher than $35 a barrel for Urals are very unlikely), but only under the most favourable scenario for oil companies — if they can export 100 per cent of produced oil.
But the tax burden grows for new fields developed under the general licence system and any PSA projects, if prices are higher — $14 a barrel for Urals, according to our estimates.

Price estimates for the near future — for example, those used to compute the 2002 Russian federal budget's revenues ($23.5 a barrel) and expenditures ($17 a barrel), or OPEC's price corridor, or the International Energy Agency's (IEA) forecast — exceed the level.
The 'fair' price range — between $20 and $25 a barrel — mentioned by Prime Minister Mikhail Kasyanov many times is also higher. True, the prime minister has not mentioned the marker — Urals, Brent etc — for which the price range is 'fair', but his reference to a particular blend would only move price range boundaries a dollar or two up or down. Anyway, the prices within the 'fair' range are higher than the critical level we estimated.
So, the introduction of the specific rate for the production tax to be applied between 2002 and 2004 in fact increases the tax burden on new projects and PSA projects and (within the anticipated price range) discourages investment.

If estimates are made for actual shares of exports, rather than for 100 per cent exports, the

situation is much worse for various groups of companies.
The overall conclusion is that the lower, provided that all other conditions are similar, is the share of exports in a company's production, the lower is the critical level of world oil prices, under which (with account of the margin between domestic and world prices) the production tax is higher than combined taxes it replaces **(see Fig. 3)**.



In our study, we have estimated the consequences of the production tax's introduction for various groups of companies (vertically integrated oil companies and smaller and mid-sized companies) with various export quotas (30, 60 and 100 per cent), for projects implemented in various natural conditions.

Correlation methods for domestic and world oil prices were applied as proposed by Vladimir Grushin, an analyst with the Foundation, which has made it possible to find dependencies between price dynamics and the share of considered taxes in prices. This allowed defining price ranges within which the tax burden (of the production tax and taxes it replaces) is really comparable for various groups of oil companies, and average critical price levels for each group.
Naturally, companies with different export quotas (vertically integrated oil companies and smaller and mid-sized companies) find themselves in different 'weight' classes.
Therefore, a higher share of exports for smaller and mid-sized companies, on the one hand, raises the 'critical' price level — under which the production tax's burden is greater than the burden of taxes it replaces — higher for them.
Those companies are more vulnerable to price fluctuations, and their higher export quotas only reduce their risks, costs and losses related to price fluctuations, but do not eliminate them.

The lack of differentiation mechanisms for the production tax to take account of a stage of an investment project and properties of a developed field cannot encourage potential investors.
The flat fixed ad valorem rate of the production tax to apply to all projects from 2005 (rather than a rate fixed for each particular project within a legislatively established broad range — which used to be the case with royalties) means the toughening of the tax burden for all groups of subsoil users. For PSA projects, this is true for any price ranges — the production tax rate of 8.25 per cent, rather than the actual royalty rate of 8 per cent.
True, investors under PSAs can negotiate compensation for this toughening of the tax burden with the state and have profit oil shares reviewed in their favour.

For projects implemented in the general licence system's framework, the introduction of the production tax means a higher tax burden when oil prices are higher than $12 a barrel or 2,600 roubles a tonne.
The market price of oil in the domestic market (for trade between independent parties) already exceeds the level. It is also very likely that by 2005 the price of oil within the oil sector, which is now about 2,000 roubles a tonne and reflects transfer prices used by vertically integrated companies, will also exceed the critical level.

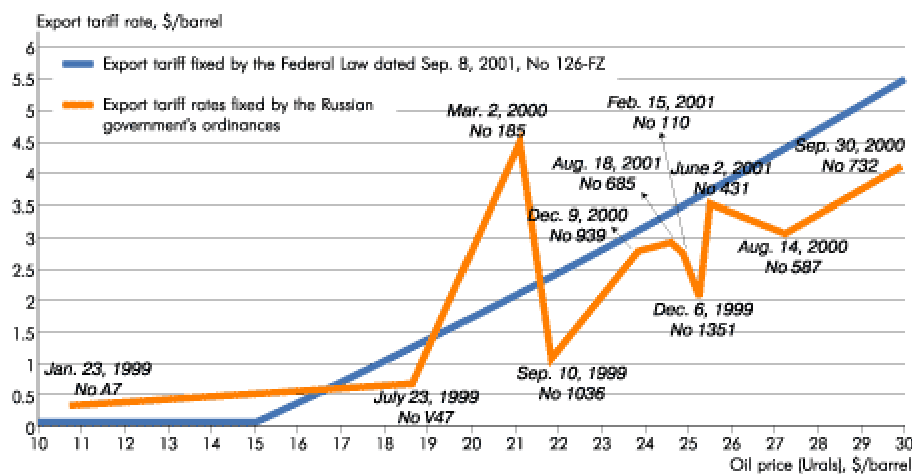
So, both under the general licence system and under PSAs, in 2005 and later the production tax will be a heavier burden for oil companies than the taxes it replaces.

Customs tariffs

On January 1, new rates also took effect for oil export tariffs. The most important innovation here is that tariff rate caps are at long last fixed by the law **(see What the law says)**.
This law fixes the mechanism for defining customs tariffs which corresponded to the ratio of prices to tariffs at the moment the law was adopted and dependencies between prices levels and tariff rates.
Our analysis shows **(see Fig. 4)** that within the ranges of anticipated 'fair' world prices at $17-$18 a barrel) or, according to Mr Kasyanov's definition, higher than $20-$25 a barrel, the tax burden on oil companies due to export tariffs will be somewhat higher than that previously established by the government's ordinances.

What the law says
Article 4 of the Federal Law, No 126, dated August 8, 2001, made amendments to the Russian Federation Law on Customs Tariffs, No 5003-1, dated May 21, 1993. Rate margins have been fixed for oil export tariffs: — 0 per cent — when average prices for the Urals blend in the world markets (Mediterranean and Rotterdam) over the preceding two months were up to $109.5 a tonne (around $15 a barrel); — up to 35 per cent of average prices for the Urals blend in the world markets over the preceding two months less $109.5 a tonne — when average prices over the preceding two months were between $109.5 a tonne and $182.5 a tonne (around $25 a barrel); — up to $25.53 a tonne and 40 per cent of average prices for the Urals blend in the world markets over the preceding two months less $109.5 a tonne — when average prices over the preceding two months were higher than $182.5 a tonne. According to the government's Ordinance of August 18, 2001, export tariff rates for oil exported outside the territory of member countries of the Customs Union are fixed at 23.4 euros a tonne (the previous rate was 30.5 euros a tonne). This roughly corresponds to tariff rates established by the new law for oil prices of $23-$24 a barrel (the price level as of the moment the ordinance was issued).

This is certainly bad for oil companies.
But, in my opinion, there are two positive things outweighing the negative aspect.
First, there is now rigid dependency (which did not exist before) between the level and dynamics of world prices, on the one hand, the level and dynamics of export tariffs, on the other.
As the new export tariffs schedule only took effect on January 1, drops in world oil prices after the law's adoption did not automatically lead to cuts in customs tariffs, because customs continued levying them under the Russian government's Ordinance 685 of August 18, 2001.



Second, the fact that customs tariffs are fixed by the law is positive for investment activities.
The government has lost the ability to fix new customs tariffs rates at its own discretion, making it hard for oil companies to plan their taxes, as tariff rates were unpredictable even for the next quarter of the year.
The government regarded customs tariffs as a tariff regulation instrument. It obviously used it to resolve its budget problems, which, perhaps, explains abrupt changes in tariff rates fixed by governmental ordinances **(see Fig. 4)**.
The fact that customs tariffs are now fixed by the law reduces investment risks (the cost of borrowing) for oil projects due to greater stability and predictability of customs tariffs and the transparent mechanisms for fixing them.

The government itself benefits in economic terms, even though it loses such an important administrative lever.
As world oil prices changed, the government always reviewed customs tariffs with a certain lag, which meant that the tax burden (if customs tariffs are regarded as an element of the tax system) grew heavier for oil companies when prices went down.
But when prices were on the rise, delays with the introduction of new customs tariffs worked against the government's interests.
The new mechanism will minimise those losses by companies and the budget.

This article is based on the results of a study conducted by specialists at the Energy and Investment Policy and Project Financing Foundation. Its complete results will be published at the end of this month or in February by the AMA Press publishers under the draft title "Reform of the tax system in Russia's oil sector: Preliminary estimate of consequences for investors". See the foundation's Web site for details: www.enippf.ru (Editors)