# Tax Code bill set to bolster investment, but requires redraft

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The State Duma approved on first reading this month a package of draft laws that could radically change the way Russian natural-resource producers are taxed.

In its current form, the package is likely to encourage investment, particularly in the oil sector. But, for it to be truly effective, many more improvements are needed before the bills become law.

As approved by the Duma on June 7, the package included draft chapters 26 and 27 of the Tax Code, which were prepared by the government.

Draft Chapter 26 provides for a new import-export tariff regime, where the details of the tax regulations and their enforcement would be established by a law and not government decree.

This appears to be a more pro-investment than the existing regime. It would provide greater stability for oil companies and would significantly decrease export-related project-financing risks for the industry.

Draft Chapter 27 radically changes the current taxation of oil and gas production by introducing a new tax on the production of raw materials.

This new tax is set to substitute the three kinds of existing taxes: royalties (6-16 percent of gross revenue), mineral-resource taxes (10 percent of gross revenue less than the value of company spending on exploration) and excise taxes (55 rubles per ton of oil).

The proposed tax regime, if passed into law, would be equal to 16.5 percent of gross revenue from the sale of oil and gas.

But for the period 2002-2004 — only for oil — the tax would be valued on a flat-rate basis equal to 350 rubles per ton of the "floor" take, deflated by the Brent "marker" crude spot-price fluctuations.

According to the government, the main reason for introducing the new "special" tax-collection regime, was to move the tax burden in the oil industry further "to the well-head" in order to extract the maximum economic (mineral) rents generated by the natural-resource producing industries.

The government would like this tax to act as an antidote for transfer pricing, which has been broadly used by the vertically integrated companies in their tax-managing practice in order to overcome excessive tax pressure.

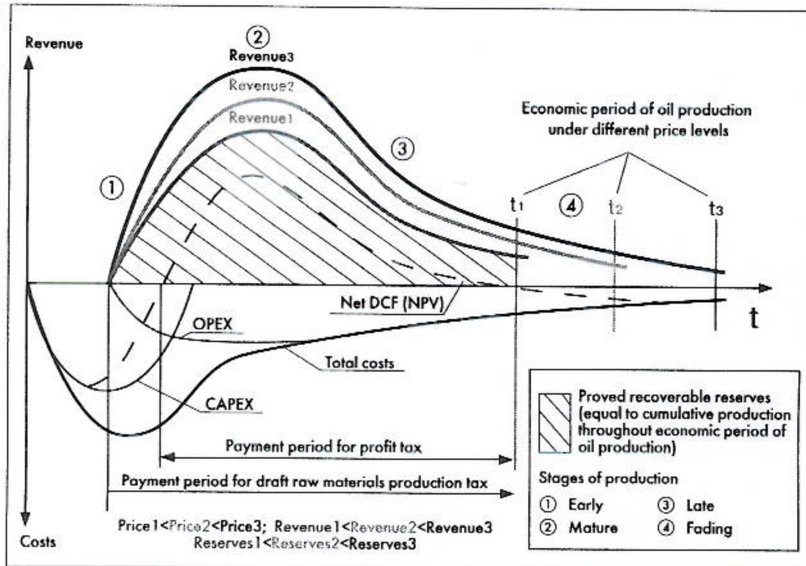
But would the proposed tax system allow for a fair and effective organization of the mineral-rent collection process? Would it really provide enough stimuli for investment in oil and gas — investment that is badly needed for new exploration and production to compensate for the depletion of the existing fields?

### TAX ON PRODUCTION VS. ROYALTY

Both royalties and mineral-resource taxes, as well as taxes on production (meant to substitute the latter) are similar in their economic nature.

All of them are gross revenue-based taxes and thus mostly depress investments in oil and gas, especially at the early stages of production when a company faces the negative net present value (NPV) of an oil-producing project.

At first glance, implementing this new tax system appears to be rather pro-investment because it strongly decreases the maximum rate of cumulative revenue-based taxes (from 26 percent to 16.5 percent).




*The above graph gives a dynamic picture of financial flows during the oil-field investment process.*

But that's in theory. In practice, the all-Russian average royalty take slightly exceeds 8 percent, according to the Natural Resources Ministry. So the real decrease in maximum take is not 9.5 percentage points (26 minus 16.5), but only around 2 (18+ minus 16.5).

Under the current law, a fixed royalty rate for a single project can be established in the broad range of its values equal to 10 percentage points. And the negotiating character of this procedure is not clearly drafted in the legislation.

But in practice, investors can prove to the authorities in feasibility studies the particular royalty rate needed to reach an appropriate IRR.

As I see it, allowing for the possibility of varying the appropriate royalty rate for an individual project is a pro-investment measure. This allows for a project to seek a balance of interests between the state and investors, taking into consideration the "natural" characteristics of the latter.

By proving an appropriate royalty rate in a given range, an investor can try to compensate the less attractive geological, geographical, etc. conditions of a particular project.

If this can be accomplished, the project should be implemented, thus generating for the state flows of direct, indirect and multiplier effects from a given project.

One needs to bear in mind, in this regard, that indirect effects for the state, created by the "costs" (spending) of the oil project in the non-oil industries, can strongly exceed direct effects (oil taxes) created by the "revenues" of an oil project. Any multiplier effects will be more or less significant compared with its indirect effects.

The implementation of a fixed (non-negotiable) royalty in the form of a tax on production — twice as high as the current effective royalty rate collected — will narrow the aggregate taxable base of the oil industry because it will increase the "floor" economic limit (volume of proved reserves) of the individual fields to be developed under new tax system.

As a result, the state will not receive incremental direct, indirect and multiplier effects from these non-developed fields.

The fixed royalty rate will also narrow the taxable base for profit tax in individual projects.

**Distribution of the aggregate (direct plus indirect) effect from the implementation of PSA oil projects in Russia between the budgets of different levels, % of total aggregate effect**

| Characteristics of the project | Budgets | | |
|---|---|---|---|
| | Federal budget | Regional budgets | |
| | | Of the oil-producing region | Of the machine-building region |
| (1) With one technological re-allotment | | | |
| Onshore: | | | |
| - small | 20 | 50 | 30 |
| - large | 20 | 30 | 50 |
| Offshore | 40 | 40 | 40 |
| (2) With five technological re-allotments | | | |
| Onshore: | | | |
| - small | 30 | 50 | 20 |
| - large | 30 | 30 | 40 |
| Offshore | 50 | 20 | 30 |

(1) Only purchase of equipment is taken into account
(2) The subsequent stages taken into account are: purchase of equipment, manufacturing or assembly of equipment, manufacturing of accessories, processing of raw materials, production of raw materials

Source: A.Konoplyanik [ENIP&PF]

Under a tax on production with fixed and high stakes, to be paid from the very start of production, investors have fewer opportunities to reinvest their revenues into CAPEX at the most capital-intensive development phase.

That means they will need more external (debt) financing for a project, which will increase costs (cost oil) and decrease the net revenue for profit tax collection.

### TAX VS. PRODUCTION CURVE

The new tax creates a simple and transparent system of oil price-related rent collection. That is a pro-investment point, taking into consideration a major externality, which has the same influence on all export-oriented oil projects.

But the proposed system will not effectively collect the "mineral" rent because it does not differentiate tax stakes — neither in relation to the individual characteristics of different fields, nor in relation to the different stages of an oil-producing investment project (i.e., internalities of the project) — and thus does not take into consideration the production curve or NPV curve.

In my view, a balanced way to tax oil production must take into consideration the following financial trends any project is likely to experience of time:

- A portion of economic rent in the price generally changes according to the production curve. That demands adequate changes in the aggregate tax burden on the investor;
- The "economic" risk of an oil field's development decreases at first, but then starts to grow following unit-cost changes;
- An investor receives from the project only one group of effects (profit, i.e. direct effect), while the state receives three groups — direct, indirect and multiplier effects. At different stages of an oil field's development, the role of each individual effect in the aggregate sum-total for the state differs greatly. Direct tax effect (including the effect of "special taxation," which is the case in Chapter 27) will be a major one only at the mature stage of a field's development. At other stages of production (early, late and fading), the state will receive a dominant share of receipts from a project through indirect and multiplier effects;
- The tax burden might be fiscally oriented, but only at the mature stage. At other stages, fiscal pressure on an investor should be reduced, even eliminated, from the special taxation at the fading stage. That will enable the state to receive "in practice" maximum value of the aggregate sum-total of three effects through project life, despite current maximization of only one group of direct effects "in paper" (excessive taxation prevents to start up a number of projects);
- Throughout all production stages, taxation needs to be differentiated in order to take maximum consideration of the different conditions of the individual project, and thus to optimize its economic (including mineral) rent collection.

In my view, the bills drafted by the government and approved by the State Duma in the first reading on June 7 — in particular, draft Chapter 27 of the Tax Code — do not take into consideration these financial trends.

Moreover, the major tax regulations presented by the government in this chapter contradict the principles (including tax-related ones) presented by the very same government in its latest long-term energy-related development programs: "Key Provisions of a Conceptual Framework for Russian Oil and Gas Development" and "Russian Energy Strategy to the Year 2020."

Both documents say that creating an oil and gas tax regime that is differentiated throughout a project's lifecycle is a must, as well as a system of pro-investment stimuli at different stages of production. The latter might include:

- At the early stage, where the dominant effects for the state are indirect effects from CAPEX plus multiplier effects generated by indirect ones: tax holidays, tax allowances on the value of reinvestments to the project (which currently exist for the profit tax), diminishing of the revenue-based taxes, investment-related tax credit (i.e., tax-related uplift), etc.;
- At the mature stage, where the dominant effects for the state are direct effects (oil-related taxes) plus multiplier effects generated by direct ones: differentiation of all "special" taxes based on "internal" characteristics of the project;
- At the late stage, where the dominant effects for the state are indirect effects from OPEX plus multiplier effects from indirect ones: differentiation of all "special" taxes, and a decrease in their values through depletion allowances;
- At the fading stage, where the dominant effects for the state are indirect effects from OPEX plus multiplier effects from indirect ones (mainly from salaries): differentiation of all "special" taxes and further decrease of their values up to zero level.

Further incorporation into legislation of these pro-investment mechanisms is a major task for the Duma deputies when they prepare for the second reading of the draft of Chapter 27 of the Tax Code.

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