Revenue Management in Hydrocarbon Economies

Hydrocarbon Fiscal Regimes

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Overview

- The purpose of a hydrocarbon fiscal regime
- Aspects of fiscal regimes
- Main types of fiscal regime
- Gas and other points
- Conclusions

Government's and investors' aims

<u>Aligned</u>

- Successful projects to generate high returns

<u>Government</u>

- Maximise value from natural resources – probably including attracting foreign investment
- Development and socioeconomic benefits

<u>Investors</u>

- Returns consistent with level of risk
- Projects consistent with strategic objectives

The risk factor

- Globally and historically little more than 1 in 10 exploration efforts have been successful
- Companies (and governments) have to assess and take account of the level of risk associated with each projects
- Fiscal regimes need to reflect risk levels, take advantage of a low risk environment, compensate for high risks

Progression and regression 1

Regressive:

- Includes upfront payments (signature bonus) or payments that do not reflect net returns (royalties & production taxes)
- So government’s share does not necessarily reflect economic outcomes
- Can give more stable government revenue earlier
- But can also distort investment decisions and deprive government of a share of upside outcomes

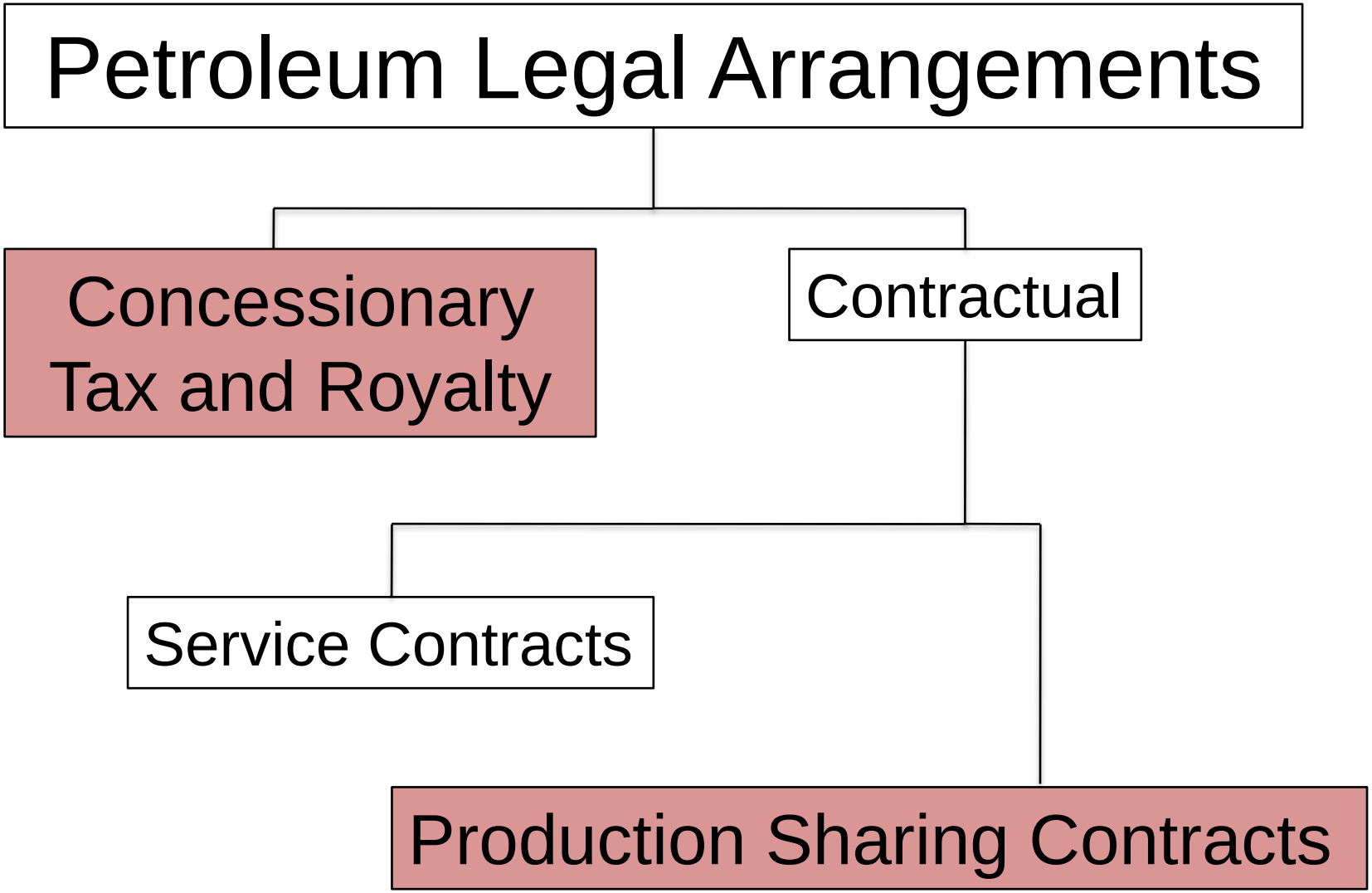
Progression and regression 2

Progressive:

- When project returns increase, so does the government's proportionate share of revenue
- But at low returns (e.g. initially or in low price periods) government share is also low
- Outcome may be more volatile
- May operate in conjunction with a threshold cumulative cost recovery/return level
- Usually non-distortive for investment behaviour, unless government share becomes very high
- A straight corporate tax on net profit is neutral

Types of fiscal regime

- The form of the fiscal regime depends on the legal arrangements – tax is not the driver
- Two main types of system (many variations)
  - Concessionary – Tax and Royalty (T&R)
  - Contractual – commonly Production Sharing Contracts (PSC)
- Both can be designed to give the same fiscal result
- Both can exist in the same jurisdiction – as in T&T - for different projects


Petroleum Legal Arrangements
Concessionary Tax and Royalty
Contractual
Service Contracts
Production Sharing Contracts

Tax and Royalty Regime

- Company owns the oil and gas from the wellhead, subject to royalties in accordance with its licence
- Company is subject to taxes and levies in accordance with public statute
- There may be ring-fencing, and taxes can be fine-tuned to treat different projects differently
- Government is effectively a partner in the project – but only indirectly

Royalties

- Historically most common form of resource tax
- Based on volume or on value at wellhead
- Typically 10-20% of gross revenue
- Provides an upfront basic revenue stream once production starts
- Easy to predict, calculate and collect (for oil)
- But difficulties when applied to gas
- Always regressive to some degree

Production taxes

- Similar to royalties but may have simple deductions
- Rates may vary on sliding scale according to price
- Always regressive to some degree (but maybe less than royalties)

Corporate profit taxes

- Either standard corporate profit tax (UK, US) or a Petroleum Profit Tax (T&T) or a special rate for petroleum activity (Norway)
- Based on net accounting profit, adjusted for tax purposes – usually to encourage or discourage particular investment behaviours
- With a single rate it’s intrinsically neutral and non-distortive
- Can be combined with sliding scale of rates to make it progressive

Production Sharing Contracts 1

- Government is clearly in charge and sharing in the project, directly taking a share of the value outcome
- Incorporates much more than only fiscal provisions (elements found in licences for T&R)
- May be more audit
- Many different variations and models
- Investor may have exemption from some taxes, or have profit taxes paid on their behalf out of government’s share

Production Sharing Contracts 2

- Investor may have exemption from some taxes, or have profit taxes paid on their behalf out of government's share
- Can be tailored to specific geological/commercial situations
- Production sharing takes account of recovery of contractor's investment
- Usually ring-fenced

Flexibility and stability

- Plenty of surprises in this business
- When conditions change, or outcomes are unexpected, may want to change fiscal conditions
- Easier in a T&R regime (amend the law) than for a PSC (renegotiate)
- Investors want stability – but manage to live without it (UK) if the process is right

Gas

- Where’s the market (or markets)?
- Lower revenue for the same or higher investment and costs
- Needs different fiscal terms

Other points

- International considerations – investors' home country tax
- Valuation issues and transfer pricing
- Admin and auditing capability
- Simplicity

Conclusions?

- Flexibility
- Progression to a degree
- Stability – or a consistent process for change
- Always take account of risk
- Tailor the fiscal to fit the project
- More openness