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Principles of a flexible and stable petroleum fiscal framework

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"There are few areas of economic policymaking in which the returns to good decisions are so high – and the punishment of bad decisions so cruel – as the management of natural resource wealth," noted Philip Daniel, a reputed expert of the IMF. One of the most important tools in the management of natural resources is the fiscal regime of petroleum exploration and production.

Petroleum fiscal policy is a key instrument through which producing countries aim at getting as large a share of the economic rent generated by oil and gas extraction as possible. Governments also promote socio-economic objectives: jobs, technology transfer, infrastructure projects, macroeconomic stability by means of steady budgetary incomes etc. Under concession regimes, title holders seek to obtain profits that are proportional with the degree of risk they take when investing in exploration and production. In order to achieve such objectives on the long term, it is paramount to have a transparent, predictable and internationally competitive regulation environment.

However, fiscal stability seems to be harder and harder to achieve, as in the past 15 years international oil markets have become unprecedentedly volatile. Between 2002 and 2008 the Brent barrel price rose fivefold to the historical level of $147, only to fall to $46 within the following three months; then, it went up again to reach $127 at the beginning of 2011, where it stayed relatively stable until the summer of 2014; the price then collapsed 60% from $114 till the year's end, hovering under the $50 dollar level at present.

The volatility of international oil quotations has challenged the stability of petroleum fiscal frameworks. Thus, starting in the mid-2000s, several producing countries showed their frustration at the fact that fiscal terms failed to generate the expected economic rent. Such governments wanted to renegotiate the fiscal terms in their favor. By the same token, cheap oil pushes companies to ask for milder fiscal treatment, in order to be able to pursue their investment plans. Given that the economic cycle of petroleum projects is about 30 years on average, it is quite a challenge for a petroleum fiscal framework to remain stable for so long, under high oil markets' volatility.

At the beginning of 2015, the Romanian Government started a process of revising the fiscal regime for the oil and gas upstream activities. This happened under public pressure

stemming from the misconception that the old royalties' framework expired at the end of 2014. The confusion, also fueled by a mix opportunism and ignorance in politics and mass media, was between the expiry of the 10-year stabilization clause in the Petrom S.A. 2004 privatization contract and the presumed duration of the "old" royalties' framework.

Nevertheless, a stabilization clause is a mere contractual provision practiced worldwide which guarantees the parties – investors and state alike – that the fiscal regulations in place at the time of contract conclusion stay unchanged (or do not impose higher rates of tax) during the clause's period of validity. Typically, such stabilization clauses include recourse to arbitration, to determine adequate compensation and adaptation measures. Now, the stabilization clause in the Petrom S.A. privatization agreement expired on 31 December 2014. However, the clause itself has not hindered the government from initiating changes of the petroleum fiscal regulations, if it so wanted, at any time before that deadline of after that, as long as these would not have applied retroactively. In other words, any such fiscal changes could only concern new petroleum agreements.

Romanian Government's new approach to the oil and gas fiscal regime has all the features of a rigid framework, with meager chances of remaining stable on the long term. Other than minor changes in the royalties rates (which at the moment vary between 3.5 and 13.5% for oil, and 3.5 and 13% for natural gas, depending on the volume of quarterly production) and some useful distinctions between operations types (onshore, offshore, deep-water offshore etc.), a problematic "supplementary profit tax" is introduced.

The exact rate of this new profit tax is yet undisclosed, but it is sure to raise the fiscal burden on oil companies investing in Romania way above the level of European countries comparable in terms of geology and political risk. Moreover, it is as yet unclear if the supplementary profit tax is to apply to existing concessions as well. If so, it would blatantly violate the principle that regulations are not to apply retroactively. Besides, it would amount to double profit taxation, imposed selectively and for undetermined time to a single industry. On the other hand, if the tax will not apply to existing concessions, but only to new ones, then the new tax rate will be hard to accept by investors interested in a new oil and gas E&P licenses.

Certainly, it is the state's sovereign right to tax the exploitation of its natural resources as it sees fit. However, assuming that the Romanian state's strategic objective is to have a robust oil and gas industry and support the development of new hydrocarbons sources, its long-term interest can only be to incentive oil companies to invest in exploration and development. A competent government, aware of the consequences of its decisions, ought to realize that to drastically toughen the fiscal terms (following a logic that, perhaps, could have been accepted a decade ago, when oil prices were at a record high and growing, but not nowadays, when the price has plunged by 60%) might bring some short term gains, yet is sure to cause considerably higher losses on the long-term: mothballed investments, lower revenues for the state, lost jobs, diminished or cancelled multiplier effects etc. Incentivizing investments also extends the lifespan of oil projects, and makes operations more counter-cyclic, because constant investment flows will put in place spare capacity, which is the best means to mitigate the effects of price volatility.

But how should a flexible and stable fiscal framework for upstream O&G look like? While there is no ideal prototype, suitable regardless of particular geological, economic and political conditions, such a framework needs to meet some basic requirements:

- It must be progressive, that is correlate the economic rent the government receives with the level of capital investments made by the companies. Taxes such as the special construction tax, a.k.a. the "pillar tax," are deeply regressive and unpredictable. Thus they dramatically reduce operators' motivation to invest.

- It must incorporate the oil price as a variable, sliding in a large value span from very low ($10-15 a barrel) to very high ($150 or more), so that the economic rent is always tied to the oil price. Hence, at high oil prices the state should receive a larger share of profits, while at low prices fiscal demands should not only be downsized, but also accompanied by investment incentives, such as "negative royalties" or fiscal credits.

- It must stay neutral as new distinctions are introduced, making place to new technologies and types of activities in newly discovered reserves, whose viable development requires special fiscal conditions.

Moreover, the fiscal framework ought to include as few taxes as possible that are independent of the projects' profitability, as well as an adequate system of deductions through which the operator manages its investment risk. Exploration spending should be deductible, as it makes up one of the most significant risks confronting oil and gas projects. Finally, a petroleum fiscal framework cannot be drafted without tying its complexity to the administrative and institutional capacity to regulate, monitor, and audit. Consequently such a fiscal framework has to be as straightforward as possible, so that it can be efficiently managed by existing institutional bodies.

In Romania, the calendar for introducing the framework is still vague. It is unknown if (and when) the draft that has been publicly discussed conceptually will enter parliamentary debates. In any event, is unlikely that it can offer a lasting solution, given its inadequacy to the present trends of the global oil industry. All things considered, it may be worthwhile considering drafting a new petroleum fiscal framework altogether – a modern, flexible, stable one, able to offer more than a merely short-term remedy.

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