

The Threats that Cloud Romania's Upstream Promise¹

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Laurențiu Pachiu, Founder and Managing Partner of [Pachiu & Associates](#) as well as of Energy Policy Group spoke with Natural Gas Europe about Romania's upstream sector. Pachiu has been advising international oil companies for over 20 years and he has written extensively on upstream and other issues for the business reader.

Mr Pachiu, Romania's offshore potential is quite remarkable. Do you think the current tensions between Russia and Turkey might negatively influence the development of these resources? Would the same argument apply to ties between Moscow and Kiev?

The Black Sea has long been developing into a strategic geopolitical “landscape” which is key for the entire European continent and the Caucasian region. The clash between two powers like Russia and Turkey was something to be expected. There are, theoretically, small chances for a large scale military conflict between such powers.

I hope we will not witness any escalation caused by accidents, mismanagement of military forces or isolated incidents like the recent downing of a Russian military aircraft by Turkey on the Syrian border.

Moreover, despite the strategic and military tensions between the two powers, there are strong economic interdependencies, particularly in the energy sector, which should ease the tensions. The evolution of Turkish-Russian relationships rests under the umbrella of strategic and political decisions of the western world.

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Russia wants western economic sanctions to be lifted, and Turkey is a crucial player in the European efforts to manage migration from the Middle East, to buffer the spread of the Syrian conflict and Isis/Daesh and, in the long run, Turkey is vital to Europe's energy security. Therefore, the relationship between Turkey and Russia should be regarded in the much larger context of relationships of the EU and Nato with each of the two actors.

These tensions between the two countries could affect upstream operations in the Black Sea. Military patrols, economic and environmental challenges, field unitization disputes, manipulation of domestic energy policies, the Bosphorus and its potential challenges, challenges to the development of midstream infrastructure – these are just some of the tactics that could be brought into play to stall upstream developments in the Black Sea basin.

As regards the Ukrainian conflict and the annexation of Crimea, Romania is facing quite a different situation with a strong legal component. In a study that I published in 2014 together with Professor Radu Dudau (available [here](#)), the conclusion we then reached was that the territorial delimitation of the maritime border between Romania and Ukraine, as settled under a ruling of the International Court of Justice, may be considered unenforceable towards the Russian Federation which now controls the Crimean peninsula which projects the limits of former Ukrainian maritime border to neighboring Romania.

While Russia is trying to have the sanctions lifted, I would not see any dramatic movement on this topic. However, a Russian Federation that is eager once more to develop its economy or which faces concerns over security in the Black Sea area or experiences domestic cravings for regional expansion, is always able to take a “legalist” approach to international relations, thus causing a dormant legal issue to become a political hot potato.

What about maritime borders between Russia and Romania in light of Russia's presence in Crimea? Can this sort of uncertainty be a destabilizing factor for developments of Romanian reserves in the Black Sea?

As outlined above, the Russian Federation is (following annexation of Crimea) a de facto neighbor of Romania in the Black Sea. On the legal side, the situation is still debatable.

Whatever is debatable raises uncertainty. Greater militarization of the Black Sea may further raise such uncertainty. Russia, which has a long tradition of geopolitical chess playing, is focused, particularly, on the lifting of western sanctions; on maintaining its energy market share in Europe (a desire which becomes more urgent whenever the development of a bigger Russian market share in Asia is delayed or stalling) and projecting power not only regionally, but globally (or at least retaining the attention of the international community in such way). Unless political and economic developments in the Black Sea littoral states directly conflict with Russian foreign policy priorities, we should not witness uncertainty translating into instability of Romanian offshore upstream developments.

For now, it might be maintained that Romania is itself promoting uncertainty as regards such offshore developments, by failing to manage a predictable, fair and realistic legal, taxation and commercial environment for upstream investors and to transform its energy opportunities into advantages (like, for instance, the development of gas transportation networks, facilitating and enhancing recovery of mature reservoirs or reforming its coal industry, just to mention a few).

Speaking about Romania's gas in general (not just offshore), what's the main hurdle and what's the main advantage?

Today, the prospects of Romania's gas upstream potential do not look very bright. Once a pioneer, Romania has seen a yearly output decline in production of 10% for the last 20 years. The depletion rate reaches 87%. Production blocks are highly fragmented. Crude production consist of heavy and ultra-heavy crude (35% of total), in many cases, with a high water cut, while much production relies on outdated and costly secondary and tertiary recovery technologies. A lot of gas production cannot be marketed and is rather used for petroleum operations. Production activity has become more unpopular. Another hurdle is an excessive and rigid bureaucratic environment for permitting upstream work.

Nevertheless, there is a true potential which requires political will and large investments (for tapping deep reservoirs, both on and offshore). One should also not forget Romania's long-standing tradition in the industry, which is an upfront added value for upstream projects. Important to note is also the role that Romanian can play in the Southern Corridor equation (given its extensive gas transportation network and its well-balanced energy mix which can compensate imbalances in the region and thus make the country become a true energy hub).

Romania seems to be doing well with energy issues. The country is well on its way to its 2020 renewable energy target and it is close to balance for gas and coal. Do these two factors make of Romania the best candidate for a regional gas hub?

Overall, Romania does offer potential for becoming a regional gas hub. I would though not consider it to be yet the best candidate. Romania still requires a major and profound reform of its coal industry (mostly state controlled and totally inefficient). Gas exploration, production and transportation networks still need innovative approaches, reform and development.

The best candidate in the region would be the one that can offer an efficient and stable energy trading and transport platform for the region. It appears, however, that none of the countries in southeast Europe offers this. More than that, competition for becoming a regional gas hub is likely to be counterproductive, given strong and integrated competition from Russia that is dividing and ruling the weaker Balkan countries which need to cooperate to develop a southern gas corridor. Then each country can act as its own local gas hub in an effective synergy with the other local hubs.

How can one avoid rivalries between neighbors?

What is needed is continuous dialogue between relevant stakeholders and true sharing of burdens and benefits (win-win approach). Each country should establish a corps of energy professionals to address not matters of national energy security in an isolated manner, but in a regional and European context. Southeast Europe should bring such specialists together in a continuous (perhaps even institutional) dialogue on relevant topics. Such an integrated approach would also strengthen their position in their dialogue within the EU, with partners from Russia or suppliers for the southern corridor.

As an expert in tax and offshore structures, what's your evaluation of the current tax system in Romania?

It could be maintained that, given the drop in the oil price, the tax system, once investor friendly, is becoming an actual burden for the industry. But powerful voices are lobbying the government to keep taxes high, either to boost the state revenues or to assert resource nationalism.

Today, there is a royalty ranging between 3.5% and 13.5% for oil and 13% for gas, in respect of gross production and by reference to the price established by the regulator (taken from global trading hubs), in respect of both onshore and offshore operations; a regular corporate income tax (16%), a regular dividend tax (16%), a windfall tax of 60% applied to the extraordinary revenues of gas producing companies resulted from the gradual price deregulation, a "construction tax", distinct from the existing tax on buildings (applicable, inter alia, to power plants, oil and gas wells, drilling and production platforms, mineshafts, railway/road/telecommunication infrastructure) at a rate of 1% of the accounting value of qualifying constructions, less the value of buildings/works for which the building tax applies, and a VAT at a rate of 20% (as of 2016), as well as a series of other taxes and levies payable to various state agencies to whom an operator must apply for the permits and authorizations required for petroleum activities or withholding taxes for payments to non-residents.

In general terms, although the system of government takes (royalties and taxation) is not adaptable to the volatile context of the petroleum sector, it can still be regarded as relatively fair and corresponding to the capacity of operators to contribute.

Do you expect any change? When would that happen? What would be the driver?

The existing tax system applicable to oil and gas operators/license holders in Romania (effective since 2004) has been heavily disputed for the past three or four years. The ultimate goal is to introduce a supplementary profit tax, which would be in addition to the existing royalties and corporate profit tax. A draft law is being circulated and discussed in the finance ministry (with strong input from the IMF). Industry associations are not at all pleased with such changes, particularly given the existing global context of the oil price dip. There is no certainty as regards the timing and terms of implementation of such new taxation system and as regards the extent to which such system will affect existing operators versus new operators.

The strongest driver of such legislative change seems to be mounting frustration in the government. The development of natural resources can always be used in political propaganda and election campaigns. Foreign competitors can also negatively impact developments in the upstream sector and, thus, affect the energy security of one country or

even an entire region. Romania is no stranger to these, but I consider political frustration and a greedy government are the main reasons.

Some still cannot pardon the sale of Romania's National Oil Company, Petrom, to Austrian OMV (thus, depriving a certain domestic political and business class of financial opportunities) or the export of capital or profits deriving therefrom, thus fueling economic nationalism and the attempt to compensate such "loss" by an increasing government take.

Strangely enough, nobody seems to put on the same balance the funds that have been misappropriated by means of corruption or embezzlement in Romania (dozens of billions of euros) and the substantial contributions of oil companies to the economy.

The main argument of advocates of this "tax reform" is that Romania should align itself with taxation levels similar to the ones existing in Norway or the UK. Such advocates however forget to add that Romania cannot be compared to such other countries in terms of reserves, production of hydrocarbons, the general wealth of society and the institutional capability of managing taxation.

This major taxation reform for upstream operations is however very questionable from a legal perspective. On one hand, there would be sufficient legal arguments to consider such a "change of tax circumstances" as a violation of Romania's agreements with various upstream investors which include stabilization clauses, as well as its obligations under bilateral investment treaties.

It may further be considered for such a change of taxation regime to be in breach of several constitutional principles and provisions (such as non-discrimination, equality before tax law, fair treatment, tax neutrality. Needless to say, "tax reform" is totally unrealistic in the given global and local context which is adversely affecting operators (the tax promotes double taxation, is focused on profits and not on windfall revenues driven by higher oil prices).

As indicated by Romanian industry associations, this tax reform will dramatically affect upstream operators. Projects will be scaled back or halted and this will have a knock-on effect on Romania's revenues and energy security. In terms of energy security alone, the effects of a downsizing of Romanian oil and gas operations will produce waves across the Balkans.

Limiting upstream operations will put in doubt the practicality of existing plans to expand and modernize Romanian gas transport infrastructure (partly financed with EU-projects of common interest funds), which are key to north-south interconnection and, thus, can prove to be of extreme relevance for the southern corridor itself.

With Turkey as a strategic transit country for Europe, being subject to unprecedented pressure both domestically and internationally, frozen conflicts that suddenly revive in the Caucasus region (such as the armed conflict in Nagorno Karabakh), the east Mediterranean gas developments hit by legal disputes (in the case of Israel and Cyprus) and fast-developing pipeline “alternatives” with Europe’s traditional supplier (Nord Stream 2), there should be enough reasons of concern as regards the future relevance of the southern corridor.

Mr Pachiu, thank you very much.