



Getting the Framework Conditions Right: Property Rights and Taxation Oil Sector

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Structure of the presentation

1. The Russian oil industry in transition
2. Taxation: What are the challenges? What is needed?
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The Russian oil industry in transition

- The fast growth of the early 2000s was overwhelmingly based on production from fields developed in the Soviet era.
- This was always destined to be a transitional phase, and it is now more or less over.
- Sustaining (let alone increasing) Russian oil production over the medium term will require the development of new fields.
- The fiscal/institutional conditions that made the ‘brownfield Renaissance’ possible are inadequate to the next phase.

What is needed now?

Securing large-scale investment in new fields will require, *at a minimum*, sound basic framework conditions:

- secure property rights,
- legal, regulatory and fiscal stability, and
- macroeconomic stability.

To these general conditions must be added the specific needs of the oil industry:

- reform oil-sector taxation,
- improvements in the subsoil regime, and
- well designed infrastructure policies

Taxation: what are the challenges? (1)

- The tax *burden* on the oil industry is not especially heavy, but
- the main oil-sector taxes are not profit-sensitive;
- tax administration is often very arbitrary; and
- the tax regime is still subject to frequent change.

Taxation: what are the challenges? (2)

- The natural resources extraction tax (NDPI) focuses on revenue and volume.
- It was introduced in 2002 in response to pervasive tax evasion via transfer pricing.
- It ignores field conditions and other differences in extraction costs.
- Its link to export prices can result in higher and more volatile effective tax rates on domestic sales.

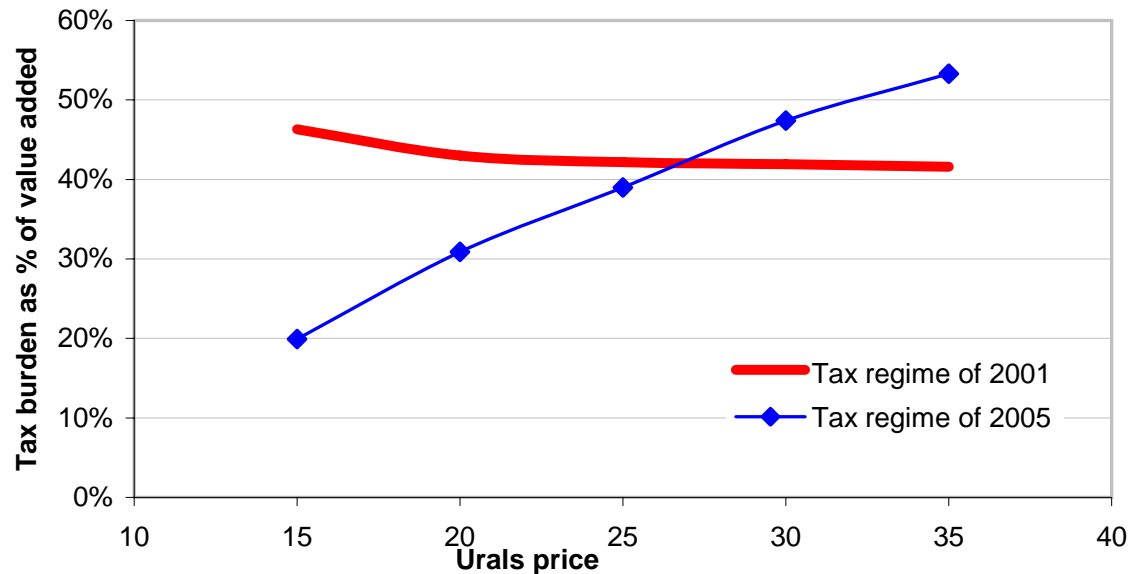
Taxation: what are the challenges? (3)

- The marginal tax on the incremental dollar on the price of an exported barrel of oil is US\$0.85-0.90.
- This allows the state to capture almost all the windfalls arising from high prices.
- But export taxes generate can distortions of their own.
- Taken together, the two major oil-sector taxes
 - render Russian supply less price-sensitive; and
 - reduce the range of potentially economic fields.

There have been some improvements

- The total burden is now lower at low prices (as it should be).
- Some shift in the tax burden from processing industry to the resource sectors (not only oil!) was undoubtedly desirable.
- The sector remains highly profitable.

The estimated effective tax burden on the oil industry at different prices



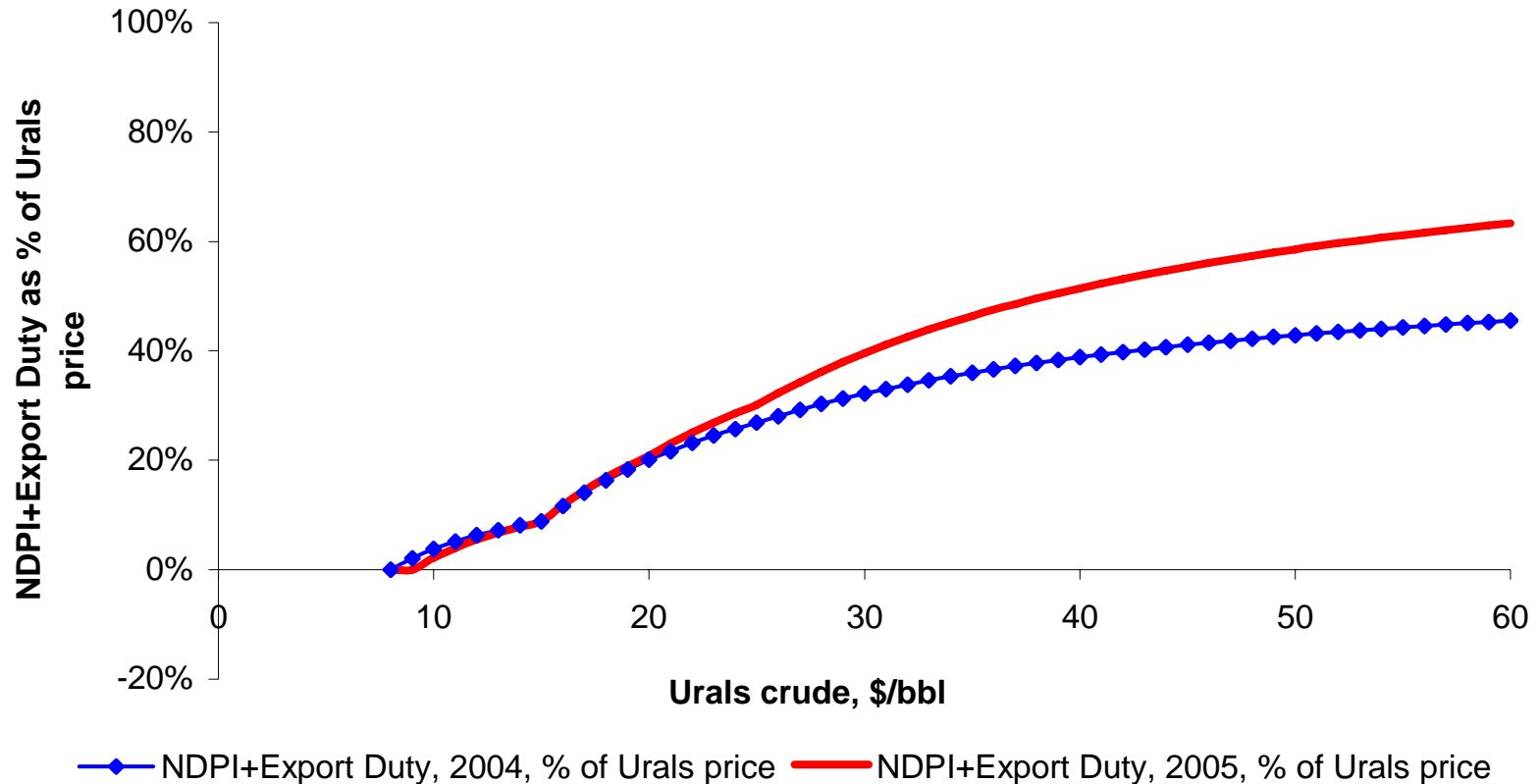
Source: Economic Expert Group, OECD calculations

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Upstream taxation and exports in 2005

The impact of changes in the NDPI and Export Duties, 2004/2005



Source: OECD

Taxation: what is needed?

- The long-term goal should be a tax system that is
 - profit-sensitive (and thus reflects actual production costs);
 - non-distorting (which probably means focused upstream);
 - stable; and
 - fairly and transparently administered.
- Interim solutions may be needed:
 - A truly sophisticated NDPI will take years to implement owing to technical complexities and weaknesses in tax administration.
 - The authorities are therefore starting with some simple – even simplistic – measures.
 - A clear tax-reform path is needed to provide predictability during the transition to a better system.
- PSAs may yet make a comeback.

Taxation: what is being done?

The government bill approved in April envisages:

- extension of the basic NDPI regime for another 10 years, until 2016;
- a reduction of up to 70% in the NDPI for fields at least 80% depleted, for companies that conduct production accounting separately for individual fields;
- NDPI holidays for new fields in Eastern Siberia until cumulative production reaches 25mt or for a maximum of 10 years from issuance of a production licence (15 in the case of a combined exploration and production licence); and
- a commitment to reduce excise taxes on low-sulphur refined products in order to stimulate production of more light-end products.

The subsoil regime: what are the challenges?

- The licensing regime is overly complex, as are the licenses themselves.
- The scope for arbitrary official action is very great.
- While actual license withdrawals are rare, the threat is often used as a source of leverage.
- Companies do not own their licenses: this can make financing more difficult.
- Incentives to explore are weak.
- The licensing regime shortens time horizons.

The subsoil regime: what is needed?

- In a word: a good property rights regime, with rights clearly defined and well protected.
- The regime should protect the state's property rights (e.g. effective control over depletion strategy), limit opportunities for insider rent-seeking, and provide mechanisms that enable the state to dispose of the resource efficiently.
- Private investors' rights need to be more secure, especially if their time horizons are to be lengthened.
- Both the above considerations point to the desirability of a shift from administrative to civil law.

The subsoil regime: what is being done?

- The government is committed to making the transition to regime of civil law agreements.
- However, the process is stalled and substantial revision of the subsoil law may now wait until 2009.
- The bill that reached the Duma in 2005, before being withdrawn, had some positive features but was poorly drafted.
 - It did not provide effective guarantees of contract stability.
 - It left many key decisions to government/bureaucratic discretion, without defining decision-making criteria.
 - It risked perpetuating the licensing regime even beyond the transition period envisaged.
 - The confused mix of administrative and civil law found in other legislation was perpetuated here.
- ‘Resource nationalism’ increasingly dominates debate about subsoil law reform.

What about export infrastructure?

- Transport constraints are tightening and expected to tighten further. When taken together with recent tax changes, this has contributed to the oil-sector slowdown.
- The problem is not aggregate pipeline capacity but the direction of evacuation routes.
- It is the policy process rather than the merits of specific routes that is troubling: decision-making is slow, opaque and politicised. Transneft's role, in particular, is problematic.
- Even if the state wants no more private pipelines, private-sector involvement in decision-making and financing is needed – as is a more transparent policy process.



Thank you for your attention.