

Oil and Gas Tax Alert

Tax maneuver Parameters and impact assessment

Introduction

As part of the tax reform launched for the oil industry in 2011, the Ministry of Finance and the Ministry of Energy of the Russian Federation have initiated the introduction of further amendments to the current tax regime in order to provide more incentives for the upstream sector and improve production efficiency. When defining the scale and scope of the so-called "tax maneuver," the authorities took into account the integration of the Russian, Belarusian and Kazakh crude and petroleum products markets within the Eurasian Economic Union agreement, which will come into force on 1 January 2015. A list of amendments to current legislation was approved following lengthy discussions between the Government and business community.

Key features of the oil industry tax maneuver

On 24 November 2014, Russian President Vladimir Putin signed Law No. 366-FZ, reducing the current rates of export duty on crude oil and petroleum products while increasing the base rate of mineral extraction tax (MET) on commercial oil. The new rates will take effect on 1 January 2015.

The new law sets the following rates of MET per tonne of oil produced:

- ▶ RUB766 from 1 January 2015 through 31 December 2015 (previous rate: RUB530)
- ▶ RUB857 from 1 January 2016 through 31 December 2016 (previous rate: RUB559)
- ▶ RUB919 from 1 January 2017 (previous rate: RUB559)

The amendments will also lower the maximum rate of export duty on crude oil (through the use of a reduced coefficient in the formula with the actual price of oil above US\$25) from the current level of 59% to:

- ▶ 42% from 1 January 2015 through 31 December 2015 (previous level: 57%)
- ▶ 36% from 1 January 2016 through 31 December 2016 (previous level: 55%)
- ▶ 30% from 1 January 2017 (previous level: 55%)



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The law also provides for a reduction in export duty rates on light products (including gasoline) and an increase for heavy products, which will be tied to oil export duty as previously.

The tax maneuver also calls for a revision of excise duty on petroleum products, changes to the calculation of MET on gas condensate and adjustments to tax

incentives, most of which will remain unchanged in absolute terms (see Appendix: Overview of the tax system in the Russian oil industry).

	2014	2015 (current regime)	2015 (maneuver)	2016 (current regime)	2016 (maneuver)	2017 (current regime)	2017 (maneuver)
Export duty on light and mid-distillates, benzene, toluene and xylene	65.0%	63.0%	48.0%	61.0%	40.0%	61.0%	30.0%
Export duty on gasoline	90.0%	90.0%	78.0%	90.0%	61.0%	90.0%	30.0%
Export duty on naphtha	90.0%	90.0%	85.0%	90.0%	71.0%	90.0%	55.0%
Export duty on fuel oil, bitumen and some other dark products	90.0%	100.0%	76.0%	100.0%	82.0%	100.0%	100.0%
Export duty on lubricants	66.0%	100.0%	48.0%	100.0%	40.0%	100.0%	30.0%
Export duty on petroleum coke	66.0%	100.0%	6.5%	100.0%	6.5%	100.0%	6.5%

Impact of the tax maneuver

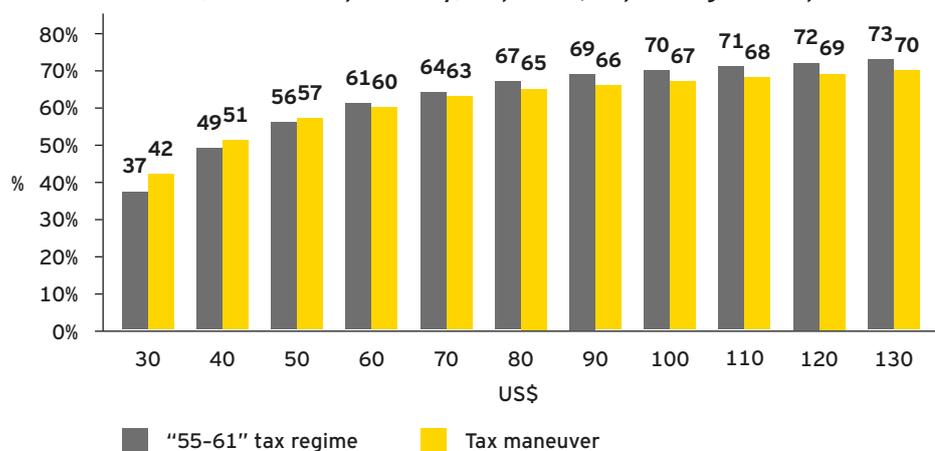
The impact of the tax maneuver depends on the selected pricing parameters. According to the EY Moscow Oil & Gas Center's estimates, the 2017 excess profits of the upstream sector can total US\$3.4 per barrel with the oil price at US\$110 per barrel, and only US\$1.5 per barrel if the price is US\$80 per barrel (zero excess profits are generated with a price at US\$55 per barrel). The overall tax burden on the oil industry in Russia remains rather high compared with other countries.

Lower export duty will make crude oil more expensive for domestic refineries and will affect their margins. According to our estimates, the complex refining margin could drop by US\$3-US\$4 per barrel by 2017, following industry modernization launched under four-party agreements among the Russian Federal Antimonopoly Service, the Federal Service for Ecological, Technological and Nuclear Supervision (Rostekhnadzor), the Federal Agency for Technical Regulation and Metrology (Rosstandart) and vertically integrated oil companies. Hydroskimming refineries may

see their margins fall by US\$10-US\$12 per barrel in the current configuration, which will make some of them unprofitable. If the oil price drops, hydroskimming refineries could face harder times as the differential between the export basket and the price of crude oil will be reduced. The fall in their average margin could be more significant.

The prices of petroleum products are not expected to spike following the tax amendments as the reduction in excise duty will be gradual.

The share of tax (MET and export duty) in profits, depending on the price of oil



Sources: Tax Code of the Russian Federation, estimates of the EY Moscow Oil & Gas Center

Appendix

Overview of the tax system in the Russian oil industry

Russian oil and gas producers pay the following taxes:

- ▶ 20% profits tax (the minimum rate may be 15.5%)
- ▶ 18% value added tax (VAT)
- ▶ Mineral extraction tax (MET)
- ▶ Payments for the use of mineral resources
- ▶ Other taxes applicable to legal entities (including assets tax and insurance contributions)
- ▶ Customs payments
- ▶ Excise duties

The main tax burden on Russian companies in the upstream segment consists of MET and export duties, which, at the current price for oil, account for more than 90% of tax payments in that segment. Companies in the downstream segment do not pay MET or make payments for the use of mineral resources, but do pay excise duties on petroleum products.

Export duties for crude oil and petroleum products

The rates of customs duties are set by the Ministry of Economic Development on a monthly basis, using average prices for Urals crude oil on world crude markets (Mediterranean and Rotterdam) during the monitoring period (from the 15th of each calendar month through the 14th of the following calendar month).

The maximum rate of export duty on crude oil is calculated as indicated in the following table, in accordance with the provisions of the Law of the Russian Federation "On the Customs Tariff":

Actual oil price in world markets per barrel (US\$)	Rates of export duty per barrel (US\$)
Up to US\$15	0%
From US\$15 to US\$20	35% × (actual price - 15)
From US\$20 to US\$25	US\$1.75 + 45% × (actual price - 20)
Above US\$25	US\$4 + 59% ¹ × (actual price - 25)

Special reduced rates of export duty are introduced for:

- ▶ Superviscous oil with a viscosity under formation conditions of not less than 10,000 mPa·s
- ▶ Oil with special physical and chemical properties produced in new oilfields in a number of remote and hard-to-reach areas, using methods that take project economy into account
- ▶ Oil from fields on the Russian continental shelf

The current rate of export duty on crude oil is US\$277.5 per tonne in the period from 1 to 31 December 2014.

Export duty rates on petroleum products are set by the Ministry of Economic Development of the Russian Federation as a percentage of the rate for crude oil.

Current maximum coefficients for certain listed categories are:

- ▶ Light petroleum products (with the exception of gasoline) – 65%²
- ▶ Dark petroleum products – 66%³
- ▶ Gasoline (including naphtha) – 90%⁴

Export duty is not charged on oil or oil products exported to Customs Union countries (Kazakhstan and Belarus).

Federal Law No. 268-FZ of 30 September 2013 introduced a special tax regime for export duties on products extracted from continental offshore projects. This regime provides for an exemption from paying export duties during a specified period.

Mineral extraction tax

MET is charged on mineral resources, including natural fuel gas, gas condensate and commercial oil.

Oil taxation

When the changes go into effect, the following formula will be used to calculate the rate of MET on oil:

$$BR \times C_P - \underbrace{C_{MET} \times C_P \times (1 - C_D \times C_R \times C_{DE} \times C_{RD} \times C_{CAN})}_{E_M}$$

where:

BR is the base rate of MET. The current rate of RUB493 per tonne, will increase incrementally over the next three years: RUB766 per tonne in 2015, RUB857 per tonne in 2016, RUB919 per tonne from 2017

C_P represents the dynamics of world oil prices, calculated by the taxpayer using the following formula:

$$C_P = (P - 15) \times R / 261, \text{ where}$$

P is the average price of Urals oil for the tax period in US\$ per barrel.

R is the average exchange rate of the US dollar against the Russian ruble in the tax period, as established by the Central Bank of the Russian Federation.

E_M represents oil extraction factors depending on the following coefficients:

C_{MET} is equal to 530 in 2015 and 559 from 2016.

¹ The maximum rate of export duty on crude oil will be 42% from 1 January 2015, 36% in 2016 and 30% from 2017.

² Based on the parameters of the tax maneuver, the coefficient will be lowered to 48% beginning in 2015, 40% in 2016 and 30% from 2017.

³ Beginning in 2015, the coefficient is to be raised to 76%, 82% in 2016 and 100% from 2017.

⁴ The rate for commercial gasoline will be lowered to 78% beginning in 2015, 61% in 2016 and 30% from 2017. The rate for naphtha also will be lowered to 85% beginning in 2015, 71% in 2016 and 55% from 2017.

C_D represents the level of depletion (L_D) of a given site's reserves. If the level of reserve depletion of a specific subsurface site is greater or equal to 0.8 and less or equal to 1, inclusive, C_D is calculated according to the following formula:

$$C_D = 3,8 - 3,5 \times N/V, \text{ where}$$

N is the amount of accumulated oil extraction at a specific subsurface site (including production losses), according to the state's balance sheet of reserves of commercial minerals approved in the year preceding the year of the tax period in which C_D is calculated.

V represents initial recoverable oil reserves.

C_D is 0.3 if the level of reserve depletion (L_D) of a specific subsurface site exceeds 1. The coefficient C_D is 1 if the level of reserve depletion (L_D) is less than 0.8.

C_R represents the quantity of a given site's reserves; it involves a reduction in MET for new minor sites. If a specific subsurface site has initial recoverable oil reserves of less than 5 million tons, and reserve depletion on the site is less than or equal to 0.05, C_R is calculated using the following formula:

$$C_R = 0,125 \times V_R + 0,375, \text{ where}$$

V_R represents initial recoverable oil reserves.

Otherwise, C_R is equal to 1.

C_{DE} represents the difficulty involved in extracting oil (type of pay zone, permeability, maximum net oil pay). C_F may be 0.2, 0.4, 0.8 or 1, depending on a combination of factors. C_F is applicable only if the following conditions are met concurrently:

- The quantity of oil produced is recorded for each well operating on a hydrocarbon deposit.
- The quantity of well fluid extracted is measured, and its physical and chemical attributes are determined for each operating well on a hydrocarbon deposit at least four times a month.

If these criteria are met, a reduced coefficient (less than 1) may be applied for within 15 years, beginning on 1 January of the year in which the depletion of a hydrocarbon deposit's reserves first exceeded 1%. In this case, the level of reserve depletion is determined not for a site, but for a hydrocarbon deposit. A hydrocarbon deposit is recognized as an item of accounting in the state's balance sheet of mineral reserves on a particular site, which was not found to comprise any other items of accounting for reserves. The level of depletion of a particular hydrocarbon deposit's reserves is calculated by the taxpayer based on the cumulative amount of oil produced on a particular hydrocarbon deposit (including production losses) and initial recoverable oil reserves according to the approved state balance sheet of mineral reserves.

C_{RD} applies to hard-to-recover oil and is calculated for a deposit, depending on the level of its depletion. C_{RD} may be in a range from 0.3 to 1.0.

C_{CAN} represents oil extraction region and properties. It will equal zero for oil produced on sites that are located wholly or partially within the borders of the Republic of Sakha (Yakutia), the Irkutsk Region, the Krasnoyarsk Territory, the north of the Arctic Circle, in the Sea of Azov, the Sea of Okhotsk, the Black Sea or the Caspian Sea, in the Nenets Autonomous District or on the Yamal Peninsula in the Yamalo-Nenets Autonomous District.

C_{CAN} is applicable if at least one of the following conditions is met:

- If the established cumulative level of oil production is not exceeded
- If the date of issue of the license, the level of reserve depletion and the development term are within certain limits
- If the site's reserves are developed within the established period

C_{CAN} will also equal zero for superviscous oil that is extracted from sites containing oil of a viscosity exceeding 200 mPa·s and less than 10,000 mPa·s.

Otherwise, C_{CAN} is equal to 1.

A zero tax rate applies to the actual amount of hydrocarbons extracted, which include:

- Superviscous oil extracted from sites containing oil of a viscosity of 10,000 mPa·s or more
- Oil extracted from a specific hydrocarbon deposit that is part of the Bazhenov, Abalak, Khadum or Domanik formations, subject to compliance with legislative requirements

Federal Law No. 268-FZ of 30 September 2013 introduced a special MET system for mineral resources extracted on the Russian continental shelf. This system involves dividing areas of the shelf into four categories of difficulty and setting a MET rate of 5% to 30% of the world oil price for each category.

Gas condensate taxation

For the purpose of calculating MET on gas condensate, the base rate of RUB42 per tonnes of raw gas will be multiplied by the base value of a unit of fuel equivalent (U_{SF}), a factor reflecting the degree of difficulty involved in gas extraction (C_{DF}) and an adjusting factor (C_{CM}).

The adjusting factor is set at 4.4 for 2015, 5.5 for 2016 and 6.5 for the period starting in 2017.

Excise duty

Excise duties on petroleum products in Russia are paid by refineries. Excise duties are charged only on petroleum products sold on the domestic market.

As set forth in Law No. 366-FZ, the list of excisable goods includes benzene, paraxylene, orthoxylene and jet kero.

Activities subject to excise taxation are limited to the receipt (purchase) of benzene, paraxylene or orthoxylene by entities holding a certificate of right to engage in activities involving these chemicals and their accounting after the chemicals are processed by a third party or in-house. Starting 1 December 2014, the tax authorities will be granting such certificates to entities that convert the excisable goods into non-excisable petrochemical products either in-house or through third parties using in-house or third-party facilities.

As for jet kero, excise duty applies only to the receipt of such fuel by an entity holding a certificate of operator from the Russian Register of Civil Aircraft Operators.

Excise duty rates on benzene, paraxylene, orthoxylene and jet kero have been set at RUB2,300 per tonne for 2015. They will increase to RUB3,000 per tonne in 2016, but will be cut to RUB2,800 per tonne in 2017.

The law sets forth a special procedure for calculating the amount of excise duty and incremental deductions regarding activities that involve straight-run gasoline, benzene, paraxylene, orthoxylene and jet kero.

The deduction is determined by multiplying the amount of excise duty calculated upon the receipt (accounting) of excisable goods by a factor set at:

- ▶ 1.37 in 2015 for straight-run gasoline (1.60 in 2016 and 1.94 in 2017)
- ▶ 2.88 in 2015 for benzene, paraxylene and orthoxylene (2.84 in 2016 and 3.40 in 2017)
- ▶ 2.00 in 2015 for jet kero (1.84 in 2016 and 2.08 in 2017)

If benzene, paraxylene or orthoxylene that has been purchased (received or accounted for) is used (disposed of) for purposes other than converting the chemical into a non-excisable petrochemical product, the taxpayer is eligible for tax deductions that are determined using a factor of 1.

If such tax deductions are to exceed the total amount of tax calculated by companies due to the use of multipliers in a tax period, the taxpayer is entitled to the refund (offset or return) of the difference received.

The new excise duty refund procedure is similar to the simplified VAT refund procedure.

Taxpayers declare the amount of excise duty receivable on the tax return filed with the tax authorities, along with details of the bank account and a bank guarantee. Taxpayers who paid a total of more than RUB10 billion in VAT, excise duty, profits tax and MET in the previous three years are not required to file the bank guarantee.

It takes five days for the tax authorities to process the documents and release the refund to the taxpayer.

The amount receivable is verified through a desk tax audit based on documents submitted jointly with the tax return.

Under Russian tax legislation, the rates of excise duty on petroleum products are differentiated by fuel quality (see the table below).

Rubles per tonne	2014	2015 (current regime)	2015 (tax maneuver)	2016 (current regime)	2016 (tax maneuver)	2017 (current regime)
Motor gasoline:						
Below grade 3	11,110	13,332	7,300	13,332	7,530	5,830
Grade 3	10,725	12,879	7,300	12,879	7,530	5,830
Grade 4	9,416	10,858	7,300	10,858	7,530	5,830
Grade 5	5,750	7,750	5,530	9,500	7,530	5,830
Straight-run gasoline	11,252	13,502	11,300	14,665	10,500	9,700
Diesel fuel						
Grade 3 and below	6,446	7,735	3,450	7,735	4,150	3,950
Grade 4	5,427	5,970	3,450	5,970	4,150	3,950
Grade 5	4,767	5,244	3,450	5,970	4,150	3,950
Oils	8,260	9,086	6,500	9,577	6,000	5,400
Heating oil	6,446	7,735	3,000	7,735	3,000	2,800
Benzene, paraxylene and orthoxylene	–	–	2,300	–	3,000	2,800
Jet kero	–	–	2,300	–	3,000	2,800
Deduction multipliers for straight-run gasoline	–	–	1.37	–	1.60	1.94
Deduction multipliers for benzene, paraxylene and orthoxylene	–	–	2.88	–	2.84	3.40
Deduction multipliers for jet kero	–	–	2.00	–	1.84	2.08

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