Occasional Memo: Historic Tax Overhaul for Russia

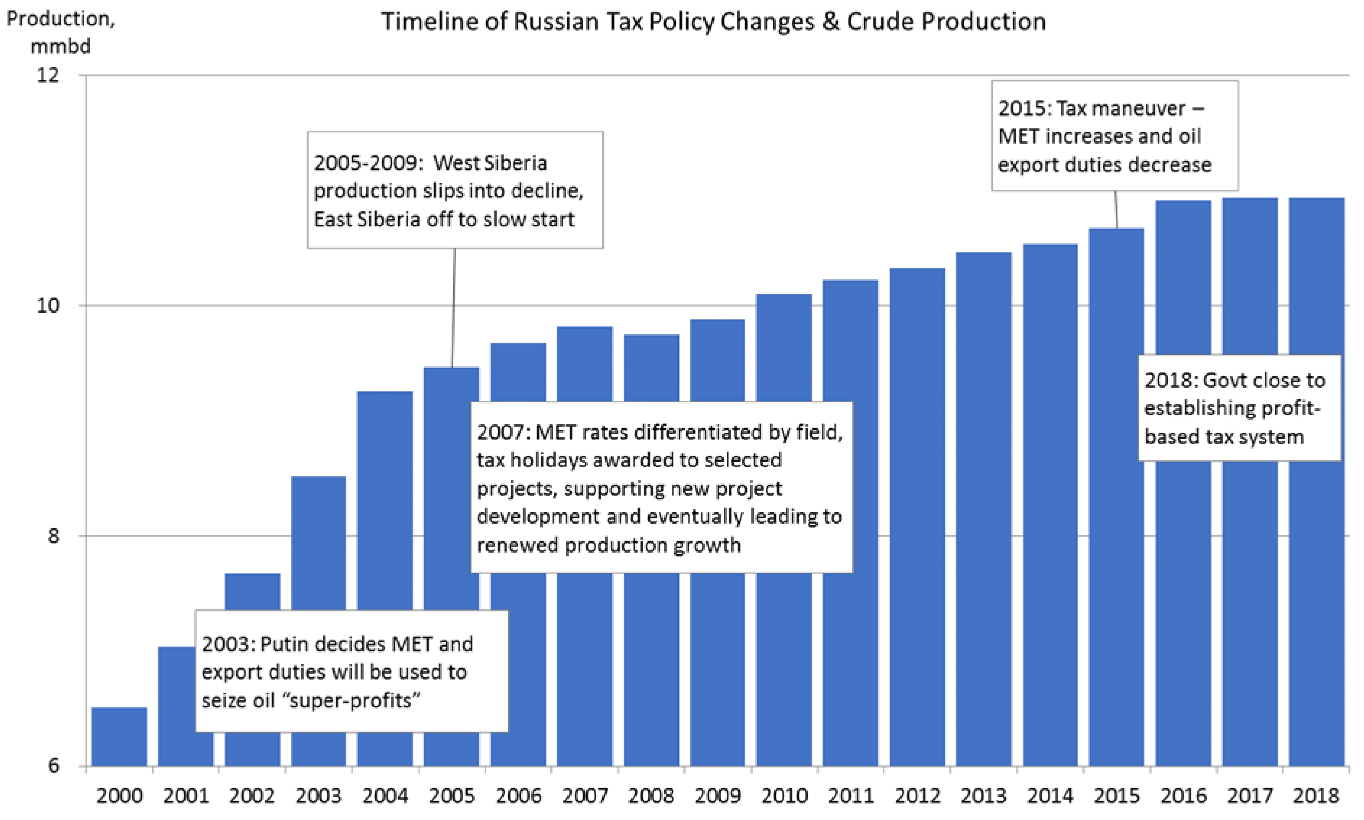
Not to be outdone by tax and other reform efforts in the United States and Saudi Arabia, Russia is close to approving a new tax system that will be a game-changer for long-term oil production. Meanwhile, government tinkering with the taxes affecting refining profitability will stymie refinery modernization.

Long-Awaited Reform to Stimulate Development of Marginal Fields

At the dawn of the Putin era, the government began debating a switch to a profit-based tax system for the oil industry. Back then, private oil companies were a potential threat to Putin's political power and President Putin sought to tame the likes of Mikhail Khodorkovsky and stamp out tax evasion. They opted for a system based on the Mineral Extraction Tax (MET) and oil export duties. However, that system considered an interim measure until the time was right for a switch to a profit-based system.The chart below shows the timing of key decisions about taxes and the evolution of Russian production.

The tax system proved more than temporary, albeit not without constant tinkering to overcome its shortcomings. One problem was that the "one size fits all" system is that it did not effectively stimulate development and production at all fields. A decade ago, the creation of a differentiated MET and tax holidays for groups of fields helped address this shortcoming. Consequently, following the 2008 decline in Russian production, East Siberian projects were launched, and Russian production growth was sustained. In more recent years, the government continued to tinker with the MET and oil export duties. Through it all, the government never lost sight of its goal of introducing a profit-based system. However, the Finance and Energy ministries repeated failed to reach a consensus about how the new system will work.

Finally, the government is reviewing a draft law that would introduce a pilot profit-based tax system as soon as 2019. Features of the draft law, which has received the blessings of oil companies and the Finance and Energy ministries, are as follows: There will be a 50 percent tax rate on the operating profit of a field. The MET and oil export duties will be subtracted from the tax in the interim period, but we presume those taxes will eventually be eliminated. Losses on new fields can be carried over to future years. Measures like this and the system more broadly is meant to stimulate the development of marginal fields and increase drilling more broadly. The pilot system will be applied to roughly 300,000 b/d of West Siberian production, certain fields in East and West Siberia, and some fields that currently enjoy tax breaks. The draft law submitted to the prime minister included speculation that the new taxes could incentivize a 2 million b/d increase in crude production by 2035. That seems optimistic, but clearly the changes will have a positive impact on Russia's long-term production.



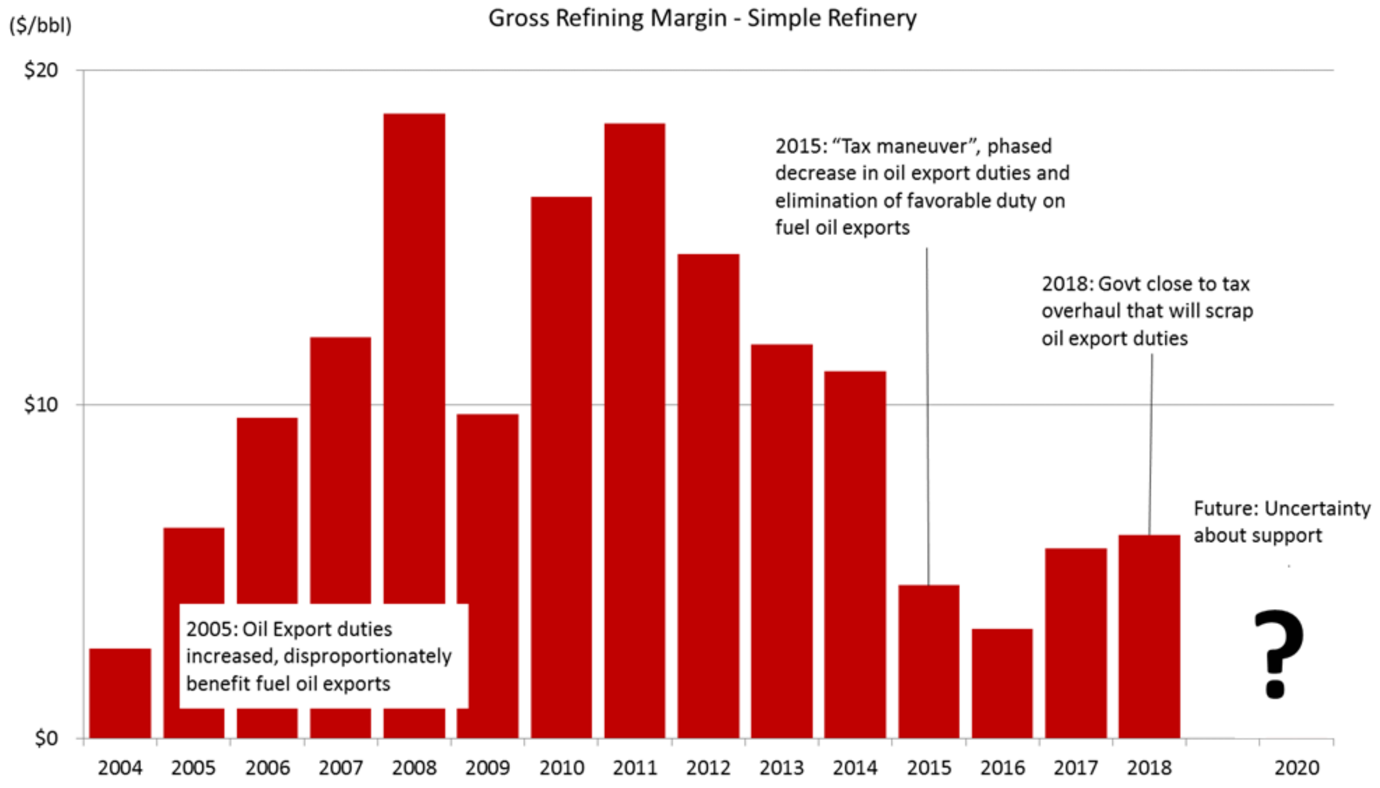
Uncertainty Stymies Refinery Modernization

Amid government "strong-arming" of refiners to invest in expensive upgrading units, the anticipated tax reform creates uncertainty about the future environment for refiners. First, the reform will upend the system of crude and product duties that made refining such a lucrative business for most of the past 15 years. It was when Russia increased oil export duties beginning in 2005 that the wide gap between the small duties paid on product exports and much bigger duty paid on crude exports triggered a decade-long "golden age" for Russia's simple refineries. The chart below shows the notional gross refining margin of a simple refinery in Russia since 2004. Refining margins only softened in 2015 when the government reduced the size of those export duties and phased in a higher duty on fuel oil. Low oil prices also contributed to smaller export duties and hence lower refining margins.

Uncertainty is nothing new for Russian refiners. Repeated government's tinkering with duties for individual products has sent mixed signals to refiners about what their investment priorities should be. Originally, the tax maneuver was expected to preserve a high duty on gasoline and a low duty on diesel. The former would have guaranteed cheap gasoline for Russian drivers but made it much more profitable for refiners to invest in diesel. This consideration probably contributed to the prioritization of hydrocracking investment that dominates the upgrading projects still being rolled out. Then the government set both the gasoline and diesel duties at 30 percent of the crude duty, providing an incentive to produce gasoline as well as diesel. Along the way, there were occasional revisions to planned changes in oil export duties as the government sought to "trim more fat" from oil companies when the government sought to shore up the flow of oil revenue into the state's coffers.

The uncertainty over refining and hence investment will increase with the anticipated tax overhaul. There is an assumption tha the new tax system will abolish oil export duties, eliminating an effective subsidy to refineries, but replace them with a new effective subsidy. The new effective subsidy will come in the form of a reimbursement of the excise duty. The excise payment for producing a ton of crude would be reimbursed for crude processed at domestic refineries. However, the size of the reimbursement and how refineries will quality is yet to be determined. Most likely, the reimbursement will favor (a) refineries with high yields of clean products, rewarding them for investment in upgrading units; and (b) inland refineries, compensating them for the high transport costs associated with exporting products. Adding to the uncertainty, in parts of the government the issue fo the ideal future size of the refining sector remains an open question.

Uncertainty over the taxes that will shape profitability in the future is one reason the refinery modernization program will only be partial success. For example, Rosneft, the company least likely to be intimidated by the government's strong-arm approach to refinery modernization, is behind on many of the upgrading investments it pledged to carry out.



Note: Assumes product basket consisting of naphtha (25%), gasoil (31%), fuel oil 44%)