MEMORANDUM: UNIVERSITY OF HOUSTON LAW CENTER RUSSIAN PETROLEUM LEGISLATION PROJECT; RUSSIAN OIL & GAS TAX PROVISIONS — "SUPERTAX" SUMMARY

This memorandum[1] primarily addresses the issue of the possible enactment of a "supertax" to be imposed on income derived from Russian based oil and gas activities. *This assumes that the overall Russian taxation regime permits imposition of such a tax—which is clearly not the present situation.*

We, as co-reporters, provide various comments below to assist your country in creating a balanced environment for internationally-assisted energy development to occur. These comments include (i) observations concerning the necessity for a defined fiscal regime, (ii) an identification of how Russia is perceived when international investor companies make international risk assessments, (iii) certain comparative information about other petroleum producing country taxing systems, and, (iv) a potential structure for a "supertax."

We are aware that the Russian Federation has indicated interest in creating an investment environment that will provide appropriate incentives to attract western interests and their investment capital. Foremost among the industries that are considering early participation in Russian petroleum development are the international energy companies. As a result of our conversations with representatives of international energy companies, they have prepared a separate statement. The essence of their position is included at Attachment One.

Although discussed in greater detail below, at the inception of this discussion we must emphasize that the total government revenue presently sought to be obtained in Russia from interna-

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1. This memorandum was addressed to Vladimir M. Lopukhin, Minister of Fuel and Energy, Government of the Russian Federation, Moscow. It was prepared by the University of Houston Law Center Russian Petroleum Legislation Project, Tax and Fiscal Group (William P. Streng, Vinson & Elkins Professor of Law, University of Houston Law Center, Houston; Ray Jones, Partner, Arthur Andersen & Co., Houston), Apr. 28, 1992 (on file with the *Houston Journal of International Law*).

tional energy companies is unprecedented. The structure of the government taxation system, which relies almost exclusively on revenue based taxes (rather than profits taxes), is strongly regressive and is certain to preclude the most necessary investments. Further, the lack of coordination among government agencies having jurisdiction over Russian based petroleum taxation creates a quite debilitating environment for encouraging international investment into the Russian petroleum sector. *Simply stated, until these fundamental matters are resolved, significant international investments into Russia will not occur.*

I. NECESSITY FOR A DEFINED RUSSIAN FEDERATION FISCAL REGIME

The structure of a "supertax" should not be considered outside of the context of the full Russian fiscal and taxing regime. International energy firms will evaluate investment potential in Russia based on a project's overall profitability and anticipated rate of return. Projections of anticipated company profitability is premised on both (i) the net effect of the total Russian "take" (of production and/or revenues), and (ii) the timing of that "take." At this time, it is difficult to gauge the net effect of the Russian fiscal regime, as that regime continues to evolve. Royalties, license fees, production sharing, state participation, import levies, decelerated cost recovery, corporate income taxes, dividend withholding taxes, mandatory conversion of hard currency, export taxes, value added taxes, and "supertaxes" have all been enacted or have been proposed at various times.

A fair, simple, and equitable fiscal regime cannot accommodate all, or even most, of the above revenue or production distribution mechanisms. The current level of total taxation prohibits serious consideration of significant investments into Russia. We include (in Attachment Two) an example of the net financial effect on U.S. energy company operations in Russia of what we understand is a major portion of the current total fiscal regime in Russia. We believe the effect to non-U.S. energy companies would be comparable. As is mentioned in that Attachment, certain material forms of "take" are not being modelled, such as the Value Added Tax (VAT) and license fees. This is because the example only shows the effect in a particular year. An economic model applying the effects of all forms of "government take" over the entire economic life of the project would need to be made to provide a complete evaluation. In

addition, the example reflects an understanding as of the end of calendar year 1991 of the Russian laws that would apply. Subsequent developments may have changed relevant laws. Even before the applicability of any type of "supertax," the net return to the international energy company is below the threshold for assuring an "acceptable" level of return.

We have attempted to assure that this example included at Attachment Two is a reasonable representation of anticipated after-tax financial results. Obviously, a substantial increase in the per barrel price of oil could significantly affect those projections. However, for present purposes, we must make these projections on the basis of current prices. We do understand the World Bank's consultant, Beicip, will provide further economic modelling which, we anticipate, will reinforce these conclusions.

II. INTERNATIONAL RISK ASSESSMENT

For international energy companies Russia is a very high-risk country. The prevailing sentiment among the major international energy companies is one of caution regarding the investment climate in Russia. The oil business is a capital-intensive and high-risk industry. International energy company representatives operate in a capital-constrained environment, which means that more potentially economic investment opportunities exist in the world than there is capital available to invest. Consequently, natural market forces have created an environment in which emerging oil and gas opportunities in countries such as Russia, Mexico, Venezuela, Eastern Europe, and others, must compete for international investment capital. Competition occurs in the relative structuring of each state's fiscal and contractual energy policy. The incentive for investment, measured as the potential for generating profits, must be commensurate with the risk entailed by investing in each country. In Russia, the composite investment risk is considered to be significant by independent experts regularly engaged in quantifying "country risk." Accordingly, increasing stability in Russia could enhance this investment environment.

Composite country risk is measured by a variety of methods. Four types of risk are generally focused upon: technical, political, financial, and economic. Technical risks are often of the greatest magnitude in oil and gas evaluations, and include concerns related to hydrocarbon sourcing, hydrocarbon migration, trap integrity, reservoir porosity and permeability, gas/oil

ratios, reservoir drive mechanisms, crude quality, project timing and logistics, availability of modern equipment, petroleum transportation, environmental issues, and a variety of other factors. Political risk evaluation relates primarily to expectations of political and social stability, including the risk of nationalization and force majeure. Financial risk evaluation looks at the time and magnitude of projected investments, foreign currency exposure, and foreign exchange rate fluctuation forecasts. Economic risk measurement takes into account inflation expectations, oil and gas price forecasts, petroleum supply and demand issues, and fiscal stability, for example. These evaluations indicate that Russia currently ranks poorly in three of the four principal categories (with an exception for hydrocarbon risk).

As evidence of these evaluations, included at Attachment Three[2] are materials from several sources engaged in measuring country risk. The International Country Risk Guide, a worldwide ranking of countries, rank-ordered according to relative investment risk as of December, 1991, has been attached. This list is compiled periodically by an independent international risk monitoring agency, Eurostudy, located in London. According to Eurostudy, recent events in Russia have moved its position within the ranking from a composite risk of 55.5 to one of 50.5, placing it more unfavorably among other nations typically regarded as "high risk." This score was probably lowered because the risk of investment in Russia is perceived as increasing, not decreasing. Similar information is also provided at Attachment Two, as excerpted from Frost & Sullivan's Political Risk Services (New York).

For additional references, other independent comparative assessments that have ranked Russia similarly are available from Business International (Geneva), Petroconsultants (Geneva), and Multi-National Strategy (New York).

2. Because of size constraints, the original Attachment Three is not included; however a summary of salient materials by the authors is provided in its place.

III. COMPARATIVE PETROLEUM PRODUCING COUNTRY TAXING SYSTEMS

You have previously made us aware of your government's interest in a "return based tax" or production sharing system. In this context Mr. Klubnichkin previously identified for us the article entitled "New Approaches to Profit Sharing in Developing Countries," as prepared by Charles McPherson (now of the World Bank) and Keith Palmer. Mr. Klubnichkin asked us to provide updated information. We have verified with Mr. McPherson and others that no subsequent information has been published to update the material provided in that article. We have not yet been able to independently update that information.

For purposes of enabling your government to make comparisons, we have sought to develop summaries of information concerning the taxing regimes in various oil producing countries. You should note, however, that circumstances in Russia are quite different from those in many of these countries. You should also be aware that many of these particular fiscal regimes are far more complex than are really necessary for your purposes. That information is attached as Exhibit Four.[3] Many of these are countries which you have specifically mentioned.

The countries examined for comparative purposes are Australia, China, Germany, Indonesia, Malaysia, Netherlands, Norway, Tunisia, and the United Kingdom. These countries are located in various geographical sectors of the world and have very different political systems and stability. You can use this information for developing your own ideas concerning the magnitude of total government "tax take" which will be feasible in your circumstances. We have omitted any discussion of VAT in our summaries because the input credit allowed for all business purchases of goods and services (including fixed assets) eliminates any economic impact of petroleum operation in those countries imposing such a tax. We do note, however, that imposition of the 28 percent VAT on total fixed asset costs with

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3. Since this memorandum was prepared, the information contained in Attachment Four has been revised and updated, and is therefore not included. The updated version of this information is available in William P. Streng, *Russian Tax Legislation Impacting Oil and Gas Operations: Endless (?) Transition*, 15 HOUS. J. INT'L L. 620, app. 3 (1993) (companion volume).

no input credit would likely destroy the economic viability of any petroleum exploration and production project in the RSFSR.

IV. POTENTIAL STRUCTURE OF THE "SUPERTAX"

If in spite of the above comments or if the remaining tax regime is moderated and a "supertax" is ultimately deemed warranted within the Russian Republic, we strongly suggest that this tax be a non-confiscatory rate of return (ROR) type tax based on the oil company's hard currency cash flows. This type of "supertax" should enable complete cost recovery, plus some reasonable return on investment, prior to the time that the "supertax" would become applicable. This structure would partially ameliorate the investment disincentive implicit in the "supertax" by allowing international energy companies an acceptable rate of return and the opportunity to participate in upside returns, albeit at a reduced level.

The threshold rate of return should approximate the minimum *risk-adjusted* rate of return required by the investor. Further, the rate of return tax would be most effective if it were applied after only a modest royalty and a general creditable corporate income tax. Consequently, a rate of return tax must be integrated with all other tax and related governmental payments. It is important to bear in mind that the relevant risk-adjusted rate of return required by the investor is project dependent, and may vary significantly, as in the instance of hydrocarbon risk in a petroleum development project versus a wildcat exploration project.

The major focus of a "supertax" regime should be to capture a significant segment of unanticipated market gains. We understand that this would be consistent with world practice. Certainly, a back-up system to capture such gains is important. However, presently, no apparent prospect exists for such "windfalls."

Included in Attachment Five[4] to this memorandum is a summary of how such a cash-flow type tax could be structured.

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4. Since this memorandum was prepared, the information contained in Attachment Five has been revised and updated, and is therefore not included. The updated version of this information is available in Streng, *supra* note 3, at 622, app. 4.

V. "SUPERTAX" AND TAX ADMINISTRATION

If a "supertax" regime is to be enacted, we suggest that this tax be administered by a central tax administration. Other countries (for example, the United Kingdom) have a central petroleum taxation bureau for the administration of special petroleum tax matters. This enables uniformity of administration and consistent treatment. An alternative mechanism to impose an "supertax" system would be through the concession or license arrangement itself. In this situation alternative administrative procedures would be required. However, each concession would presumably be different as a result of individualized negotiations, making the monitoring process more difficult.

VI. INCOME TAX DEDUCTIBILITY OF "SUPERTAX"

Since any supertax will be an additional cost of business, we suggest that it be classified as deductible for purposes of computing the Russian net income tax liability. This will also assist in assuring the possible eligibility of the income tax for creditability for income tax purposes in some Western countries. However, any "supertax" will itself not be eligible for creditability for U.S. income tax purposes.

VII. PRIOR INFORMATION

We assume that you have previously received a copy of a January 23, 1992 report (both in English and Russian) to Mikhail K. Klubnichkin which provided preliminary ideas and sought certain confirmation concerning what we believe to be your country's current tax structure.

Please promptly contact us if you have any questions concerning the discussion in this memorandum. We are prepared to assist your government further when deemed appropriate.

ATTACHMENT ONE

SUMMARY OF THE POSITION OF INTERNATIONAL ENERGY COMPANIES

We have been requested by representatives of various international energy companies to provide to you their position that any "supertax" regime would constitute a significant disincentive to the development of Russian energy resources. The co-reporters do not necessarily subscribe to all the views identified below. This position is essentially summarized below:

At this critical juncture in the evolution of the Russian market economy, a Russian fiscal policy that would include an energy "supertax," or an excess profits tax, would quite probably be counter-productive for all parties involved. A "supertax" is ordinarily perceived by Western companies as an investment disincentive and as inconsistent with the general premise of market economics.

An economic opportunity is generally evaluated on a risk versus reward basis. A low risk project is expected to provide a reasonable return on investment, and a high risk project must provide a commensurately higher level of potential profitability. A "supertax" which reduces the opportunity of obtaining a high level of profitability on a high risk project, or which goes still further and effectively establishes a ceiling on upside profitability, operates as a significant impediment to high risk investment. The prudent investor will simply not invest in opportunities that bear risk that is disproportionate to the return potential. Investment capital will be diverted to other investment opportunities where the profitability expectations are more consistent with the concomitant risks.

Diversion of capital to other countries would result in lower Russian petroleum industry activity levels, slower and less development of hydrocarbon resources, and lower revenues for the Russian Government. Note that the relevant risk adjusted profitability required by the investor is project dependent, and may vary significantly, as in the instance of hydrocarbon risk in a petroleum development project versus a wildcat exploration project. A uniformly applied "supertax" will discourage exploration in some areas. Any "supertax" system would need to be

modified to account for significant diversities existing in various petroleum developments.

ATTACHMENT TWO

SUMMARY OF EXISTING AND PROPOSED GOVERNMENT "TAKE"

Note that this summary is premised on the anticipated experience of a U.S. based company. It assumes a prevailing per barrel crude oil world price in U.S. dollars. Similar results for other western companies could be anticipated. Please note that not all assumptions may be applicable in every situation, for example, the 40 percent currency conversion factor.

		Tax Calculation	Cash Flow	Gov't Take
Revenue		18.00	18.00	
Expenses Incurred in Cost of Production				
Royalty[5]		(2.70)	(2.70)	2.70
Export Tax[6]		(4.50)	(4.50)	4.50
Operating Expenses[7]		(3.00)	(3.00)	
Wages				
Within normative limits	$1.00	(1.00)		
Above normative limits	$1.00			
Total Wages	$2.00			
Depreciation		(1.00)		
Required Currency Conversions[8]		(3.60)	(3.60)	3.60

5. Royalty is assumed to be 15% of revenue under Russian legislation to be passed.

6. Assumed to be $4.50 per barrel under Decree No. 91 of the Russian Federation of December 31, 1991.

7. Does not include wage costs which are separately stated, but does include assumed transportation tariffs.

8. Assumed to apply to joint ventures with foreign participation under

	Tax Calculation	Cash Flow	Gov't Take
Capital Expenditures		(1.00)	
Allowable Cost of Production	(15.80)		
Balance Profit	2.20		
Allocation to Reserve Fund	(0.50)		
Additional Reductions to Tax[9]	(1.00)		
Taxable Profit	0.70		
Tax at 32%	(0.22)	(0.22)	0.22
Distributable Profit[10]	0.48		
Withholding Tax at 15%	(0.07)	(0.07)	0.07
Net Distribution to U.S.	0.41		
U.S. Tax at 34%[11]	(0.09)	(0.09)	0.09

Edict No. 335 of the Russian Federation of December 30, 1991 Concerning the Formation of the Republican Federation in 1992. This effectively takes 40% of the $18 sales proceeds and converts them to rubles at one-half of their value. This results in form of government take equal to 20% of the export proceeds.

9. Russian "accounting books" would show that an amount of profit (Distributable Profit) could be distributed to the U.S. corporate investor. This is because the "books" reflect the limitation imposed on the deductibility of wages and are further reduced by allocations to the Reserve Fund and "profit used for the development of production." This latter term essentially means that certain kinds of capital expenditures can be deducted twice. The first is through a depreciation deduction. The second way is through a direct write off against balance profit to the extent there is balance profit (after reduction by the Reserve Fund) in a particular year.

10. *See supra* note 9.

11. Assumes Russian Profits Tax is not creditable for U.S. purposes, but

	Tax Calculation	Cash Flow	Govt Take
Net Cash to U.S. Investor	0.26		
Net Cash Flow[12]		0.82	
Total Russian Government Take[13]			11.09
Total U.S. Government Take			0.09

	Cash Use Recap	% of Cash Use
Russian Government Take	11.09	0.62
U.S. Government Take	0.09	0.01
Capital Expenditures	1.00	0.06
Net Cash Distributed to U.S. Investor	0.32	0.02
Operating Costs and Wages	5.00	0.27
Cash "trapped" in joint venture[14]	0.50	0.02
Total Cash	18.00	1.00

a foreign tax credit is given for the Russian withholding tax.

12. *See supra* note 9.

13. Does not show effects of other forms of Russian Government Take such as Value Added Tax, license fees, property taxes, or import duties.

14. *See supra* note 9.

ATTACHMENT THREE

SUMMARY OF COUNTRY RISK EVALUATION PROCESS

Representatives of the Tax Group of the University of Houston Russian Petroleum Legislation Project provided information concerning "country risk" in an effort to demonstrate to the Russians that international energy companies will insist upon greater return (and lesser taxation) than could be anticipated in a highly developed country. The representation is that, under present conditions, Russia is a high risk jurisdiction and, therefore, could not consider itself to be in the same category as, for example, the United Kingdom (which imposes the Petroleum Revenue Tax), when imposing taxation which significantly impacts on the cash flow return from an international energy company's efforts.

Those charts are not included here. However, the classification of Russia among the world's countries and, probably more importantly, the methodology in classifying countries on the basis of country risk is included here.

Country risk evaluation information is available from several sources, including:

1. *The International Country Risk Guide*, a worldwide ranking of countries, rank-ordered according to relative investment risk. This listing is compiled by Eurostudy, an independent international risk monitoring agency based in London.
2. *Frost & Sullivan's Political Risk Services*, based in New York.
3. *Business International*, Geneva, Switzerland.
4. *Multi-National Strategy*, New York.

Other groups provide related information. The Export-Import Bank of the United States, and similar U.S. Government agencies have also developed comparable ranking information, but that information is ordinarily not publicly available.

The information which was provided to the Russian delegation from some of these sources indicates that Russia was then classified as a high risk country. Such rankings are made on various bases:

1. political risk (e.g., turmoil potential);
2. financial risk (e.g., currency transfer risk);
3. economic risk (e.g., business success potential); and
4. composite rankings.

Rankings are sometimes made on the basis of short-term as well as longer term (e.g., five year) time horizons.

The elements included with "political risks" might include economic planning failures of the local government, instability of the political leadership, possible conflicts and uprisings, governmental corruption, military interference in governmental processes, racial and nationality tensions, civil war risks, and the quality of the government bureaucracy. Elements considered in determining "financial risks" might include loan defaults in the foreign country, delayed payments due to lack of foreign exchange, the repudiation of contracts by the local government, and the incidence of expropriation of private investment. The "economic risk" determination may be based on factors such as inflation, debt service as a percentage of exports, the international liquidity of the country, the foreign exchange position, and the current account deficit as a percentage of the country's exports.

Other criteria which can impact these various evaluation factors might include restrictions on local operations, such as on labor, management and procurement, taxation discrimination, labor costs, nontariff barriers, and restrictions on equity ownership in the local country.