

Development of the Oil Companies Taxation System

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Abstract

This publication is dedicated to the taxation of oil sector; describes the Russian oil industry taxation system; identifies the problems and specifies the development trends for taxation of oil companies. Among other things, the oil extraction tax calculation and payment mechanism will be studied for application to the Russian exploration and production sector. As the extraction tax heads the list of the taxes subject to be paid by operators, the authors conclude that the exploration and production sector needs an effective tax regulation.

Keywords: taxation, oil companies, oil extraction, exploration and production sector, extraction tax

1. Introduction

The economic activity bases on exploration and production sector, which facilitates the large share of Russian budget revenues. For a long period of time, the Russian oil taxation laws focused on keeping the budget revenue at an appropriate level by all manner of means. Meanwhile, the economic efficiency of the taxation system fell into the shade. The result was the negative tax environment that prevented the oil sector from rapid growth and increase in efficiency. The current global practice of taxing the users of subsurface resources bases on the withdrawal of rent income from the development of the field being the best in terms geological, natural and economic-and-geographic conditions in favour of the subsurface resource owner. The optimum tax systems must serve stimulating and regulating functions. The stimulating function includes stimulation of marginal oil fields or keeping on the production when the oil prices are low. The regulating function means the withdrawal of excess profits from development of high-performance features. Therefore, the Russian exploration and production sector needs the tax regulation to be enhanced.

2. Theory

The tax regulation policy of the exploration and production sector holds a special place in the government regulation of the economy due to the specificity of the methods used, which are associated with rent categories and location of production facilities. Moreover, the exploration and production sector forms the system of the present-day Russian economy. It accounts for about 30% of the industrial output and 32% of the Russian Federation consolidated budget revenues. In addition, the oil sector fully accommodates the internal needs for fuel oil. Therefore, the requirements to the quality and efficiency of tax regulation are extremely high for this sector.

Russian operators contribute to the budget by paying such taxes as income tax, value-added tax, extraction tax, individual income tax, other corporate taxes (including property tax) and by making such compulsory payments as extraction royalty tax, social costs and customs duties.

The Russian Federation consolidated budget returns for exploration and production sector are listed in Table 1.

Table 1: The Russian Federation consolidated budget returns for oil exploration and production sector [1] In thousand Rubles

Tax revenues	2011	2012	2013
Total tax revenues on crude oil and associated gas production, including:	1871639227	2164586716	2252806719
- Corporate income tax	212949710	204391369	151436495
- Individual income tax	15381247	17456722	18503855
- Value-added tax	51361257	68465083	95515165
- Excise taxes	834256	14651150	38127180
- Extraction tax	1537431099	1803815074	1888573483
- Other federal taxes and duties	842449	178421	94044
- Regional taxes	36630836	40133554	45100886
- Local taxes	194136	242883	300533
- Taxes subject to special tax treatment	16014237	15385550	15155078

The extraction tax is the basis of the Russian oil taxation system. Oil refining and selling companies are not subjected to extraction tax and extraction royalty tax, but shall pay mineral oil excise tax.

It should be also noted that the share of export customs duties is high among the non-tax payments, which are payable by Russian oil companies. The export customs duties for oil and oil products are subject to the tax regime "60-66". The main objective of the regime "60-66" is to ensure the fastest yield increase in the exploration and production sector by means of redistribution of income from oil refinery, which level is extremely high at the moment. At the same time, increasing the rate of export customs duty for fuel oil enhances the profitability of secondary refinery processes and will stimulate oil companies to invest the projects of retrofitting oil refineries.

Since 2002, Russia has been taking measures to change the procedure of taxing oil production. Particularly, introduction of the extraction tax provided for budget revenues. Today, the extraction tax is about 83% of the Russian Federation consolidated budget revenues (Table 2).

Table 2: Extraction tax of the Russian Federation consolidated budget revenues for oil exploration and production sector In percents

Tax revenues	2011	2012	2013
Total tax revenues for oil exploration and production, including:	100	100	100
- Corporate income tax	11.4	9.4	6.7
- Value-added tax	2.7	3.1	4.2
- Extraction tax	82.1	83.3	83.8
- Other tax revenues	3.8	4.2	5.3

Table 2 shows that the extraction tax takes the major part among the Russian Federation consolidated budget revenues. For the first time in the existence of the tax system, the subsoil use taxation system was distinctly regulated upon acceptance of Chapter 26 of the Russian Tax Code and the tax and non-tax payments for natural resources were clearly distinguished. The extraction tax calculation and payment conditions base on the payment procedure for subsoil use, which was in use before the extraction tax introduction, with inclusion of half-rate for recovery of mineral resources base and excise rate for crude oil.

The extraction tax being one of the components of the natural resource rent forms its base. According to many modern scholars, the existing mechanism of natural rent withdrawal through the extraction tax and export duty is originally vicious. These are the rough tools of payment collection, which are not the best derivative of the rent. At the interface it is not feasible to distinguish, from which oil field, a mature or a rich, the oil was produced. Hence, the system needs to switch to the system of rental payments well known worldwide: bonus, rent and royalty – three standard payments plus the excess profit tax in the event of unexpected price jumps. This problem remains open for discussions until now.

The oil companies taxation issues are discussed in the papers of such authors as Osmundsen, P., Løvås, K. [2], Poltavtseva, E. A. [3], Willigers, B.J.A., Hausken, K. [4], Kashani, H.A. [5], Bell, S., Hindmoor, A. [6], Leblond, D. [7]. Problems and features of taxing oil companies in Russia are discussed in the papers of such authors as Lunden, L.P., Group, S. [8], Cherepovitcyn, A., Smirnova, N. [9], Garden, E. [10] Factors that have an effect on oil extraction were covered by Khisamov, R.S., Lavushchenko, V.P., Motina, L.I. [11], Russell, A., Dawe, R.A. [12].

The incomes from extraction taxation are still the primary source of revenue feeding the Russian Federation budget system; therefore, special attention is traditionally given to the taxation of mineral resource sector with significant rent incomes when developing the fiscal tools. In recent years, the main mean of natural rent withdrawal is the extraction tax, which is payable at the production stage and the export customs duties for oil. The key factor of unstable budget revenues is that they are highly dependent on free market prices.

Tax concessions are expected for oil production from the integrated fields in the long term. This will significantly enhance the efficiency of field development, including mature fields.

The extraction expenditures will increase in the mature fields from year to year, which means that the user of subsurface resources would be likely to incur losses, but not the standard profit much less the super profit. A state that wants to extract mineral resources in full shall use a flexible taxation system with tax benefits. In many cases the market participants "skim the cream off" from the areas they have leaving a part of underused resources behind, for which the state could gain but due to the rigid taxation system it loses its potential profit. There are areas instead, which efficiency will be either much low or negative at all.

While the efficiency of any field varies highly depending on development schedule, geological features, size, distance from roads and other natural parameters, the extraction tax is common and does not consider all the conditions. Therefore, the extraction tax, which does not take field details into consideration, strikes primarily those fields with poor production climate so that many of them turned to loss-making fields and run abandonment. Of course, the extraction tax pushes the mineral developers towards the best fields and does not stimulate the production build-up by recoverable reserves.

As is seen, the existing taxation system does not really motivate the field development. In addition, the averaged rates do not provide for the natural rent body to be withdrawn from the high-yielding oil companies to the state revenue. Therefore, the present-day Russia suffers from the following disadvantages of the oil sector taxation system:

- Non-optimum distribution of taxation load in the process chain;
- The taxation system does not consider Russian specificity, which consists mostly of reserves difficult to recover;
- Imperfections in the existing tax concession system for development of difficult-to-access, inefficient and mature fields;
- Need for the extraction tax to be replaced with the excess profit tax at the stage of oil production.
- The solution of these problems is only possible if the existing oil sector taxation system is updated to a rent-oriented taxation system.

3. Results

Considering the entire importance of the matter and the specified problems, Russia needs government regulation, primarily, the fiscal regulation for further development, increase of efficiency and competitive ability of its oil sector on the world market. The oil company taxation procedure should be revised in the nearest future. Figure 1 illustrates the development trends for taxing Russian oil companies.

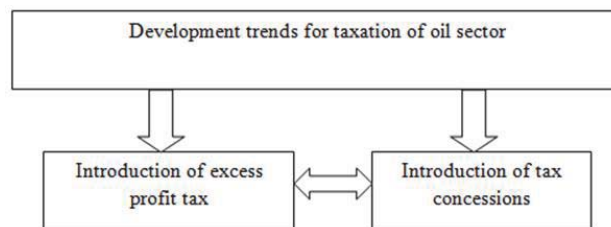


Fig. 1. Development of the oil sector taxation system

The existing Russian taxation system is not flexible as it focuses on taxing the high-flow-rate fields and does not include the objective growth of production costs with the decrease in well flow rates and growth of water cut.

Another significant problem is the existing tax concession system for development of difficult-to-access, marginal and mature fields. If the oil sector taxation remains unchanged, the oil extraction will be reduced to 395 million tons of oil by 2020. According to the experts, if the taxation system remains as it is, 90% of new field reserves and 30% of the explored fields are economically unprofitable for development. Therefore, the government faces a serious problem now –

tax concessions may reduce the budget revenues and the absence of tax concessions will drop the oil production.

Having faced the necessity to stimulate oil production in the marginal fields, the USA and Norway launched the procedure of providing tax concessions for production of hard-to-recover reserves and stimulation of oil companies, which implement technologies of their extraction by all means. The Republic of Tatarstan being one of the Russian Federation regions is an example of such approach to support difficult wells. The tax concessions taken in Tatarstan enabled not only to cease the catastrophic drop in oil production but to increase it.

Today, the extraction tax is linked to the world oil prices while the geological and geographical conditions do not consider the level of extraction tax. That is why the introduction of excess profit tax is so essential. It is important that the key budget revenues would form from excess profit tax applicable to all the existing but not only the new fields. This should be the result of financial activity of the companies but not from the returns prior to taxation. Introduction of the excess profit tax for oil production through final results of oil companies' financial activity will naturally regulate them the same way as in other countries by using the suggested oil production taxation mechanism. All of this will furnish efficient performance of existing wells, rational development of all fields (including small-sized), and remaining and in-place reserves with a high level of operating expenses that base on a differential approach to the quality of reserves.

4. Conclusions

Following the results of our study of oil companies taxation system, the following conclusions are as follows:

1. For Russia, it is a good practice to provide tax concessions to the oil companies that implement new technologies of oil extraction from difficult-to-access, marginal and mature fields and bring old wells back to life.
2. The gradual transition to the excess profit tax is required. However this procedure is a complex one and will take a while. The balance between the interests of the state and the oil sector should be ensured for introduction of the extraction tax.

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