Trends in Upstream Fiscal Terms
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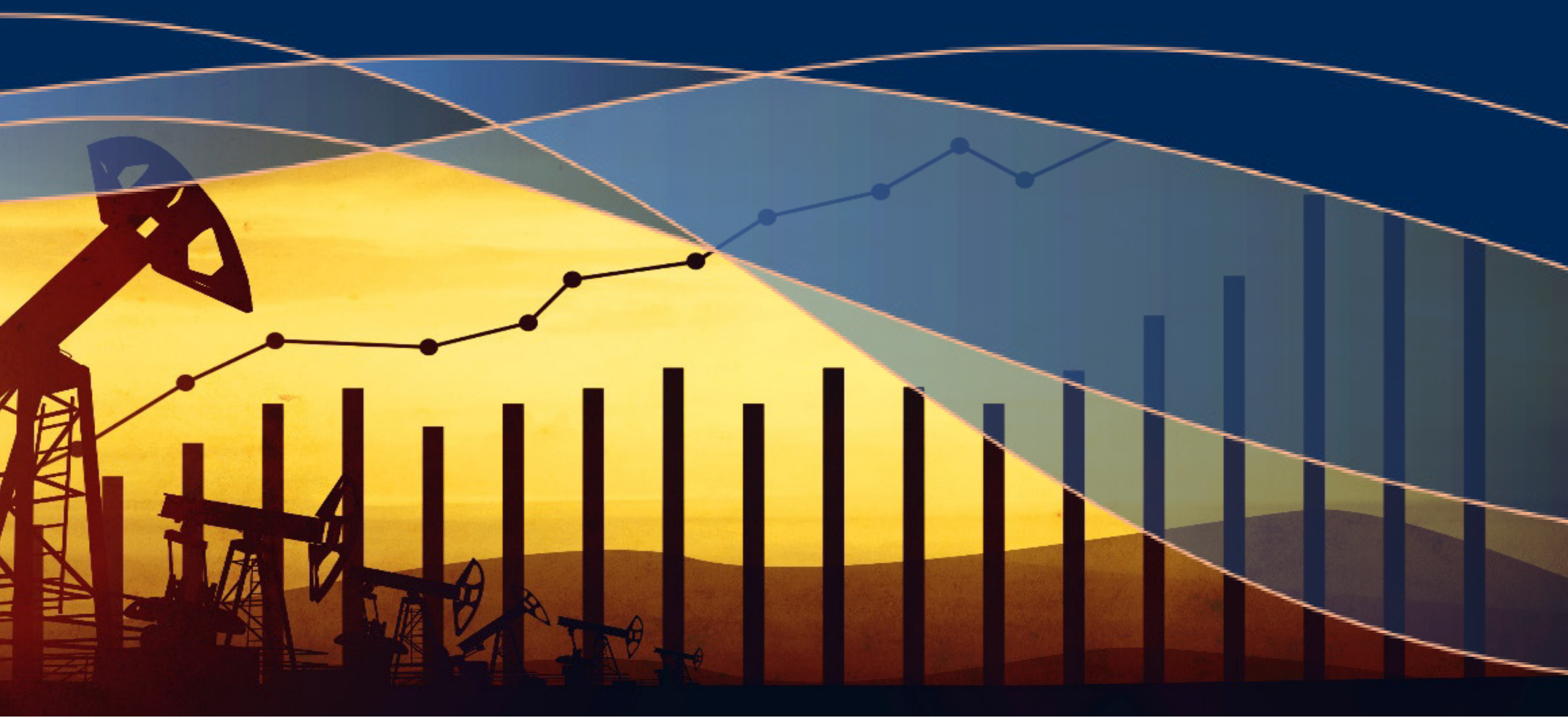

Like most things in our world, contract terms governing upstream oil and gas assets continue to evolve. For such contracts, the evolution is most significantly affected by the ever-increasing understanding of contractual elements by the industry and host governments, the changes in hydrocarbon market conditions, the maturation of basins and investor capital allocation preferences.

GaffneyCline has extensive experience of supporting upstream licensing, advising on contract negotiations and contributing towards the dispute resolution process. The short discussion that follows highlights some of the recent trends we have observed in upstream contracting, particularly relating to that of fiscal terms.

A Brief Background

In just about every country in the world apart from the US, the government is the owner of all subsurface resources, including hydrocarbons, and manages development through a government ministry or National Oil Company. Most governments have absolute discretion to manage and extract value from upstream assets as they see fit. However, in practice governments must compete for international investment. Due to the value of such natural resources, the upstream oil and gas industry is usually subject to a unique set of terms to manage the industry and determine the Government's fair share of economic rent. Thus, the level of upstream hydrocarbon taxation imposed by governments is often carefully managed, decided upon and reviewed at a national level or sometimes on an asset level.

All oil and gas upstream contracts will be referred to simply as Contracts or Petroleum Contracts, whether they be Licenses, Leases, Concessions, Petroleum Sharing Contracts, Service Contracts, etc.

Responses to Changes in Market Conditions

Firstly, the most recent and prevalent revisions have been in response to changes in hydrocarbon market conditions, most notably from the sharp downward liquids price movement at the end of 2014 and to some extent the beginning of 2020. Recognizing the contraction of global upstream investment, many proactive governments have taken steps to maintain and encourage continued upstream hydrocarbon activity. Responses to the change in 2014 are more clearly visible because of the time required to make such fiscal changes (some did not become effective for years afterwards) and because it is believed that the shift from US$100 oil in 2014 is more structural compared to the sharp decrease concurrent with OPEC decisions and the start of the pandemic in early 2020, which already shows clear signs of recovery. Irrespective, such responses have taken a wide variety of forms, some of the examples include:

- In order to mitigate underinvestment, in June 2020 Norway decided to allow immediate capital depreciation, an increased uplift (an additional premium based on the investment that can be used to offset taxes) and refunding of tax losses on a temporary basis.
- In order to protect jobs and investment in the North Sea, the United Kingdom reduced the Supplementary Tax two separate times and implemented a 62.5% investment uplift in 2015 and 2016.
- Many royalty rates for certain areas were reduced in response to 2014 including in Alberta, deep-water India and some Brazil assets.
- Reduction of export taxes in Kazakhstan (twice), Argentina, and Russia.

The above is just a sample list of changes at a national level and does not consider the changes to newly issued asset-specific Contracts, which are more commonly subject to changes when new Petroleum Contracts are issued. At GaffneyCline, we have advised on numerous contract specific renegotiations where the oil companies and host governments elect to revisit contracts governing specific assets when market conditions have changed, but such contract-specific amendments are often not seen in the public domain. We are aware of contract-specific alterations across the globe, particularly in the Middle East, Africa, SE Asia and Latin America, suggesting that such fiscal adjustments are more common than it might appear.

It may be worth noting that some practitioners argue that adjusting fiscal terms, even if beneficial to oil companies, brings an elevated risk through the perception that the same government will revise fiscal terms the opposite direction when the going gets good again. While the logic behind this assertion is clear, it is difficult to point to evidence that investment is stymied when governments provide fiscal concessions, even if there is a potentially elevated possibility of an opposite reaction at a later date. However, this argument merits consideration and may support the use of temporary concessions (such as Norway's aforementioned response) or asset-specific concessions (such as marginal field designations and allowances discussed later).

The fiscal concessions made in the attempt to maintain and stimulate investment in the hydrocarbon space usually results in losing out on some short-term tax revenues and often seems to conflict with other climate change initiatives. Despite these drawbacks, many governments have made fiscal concessions, clearly conveying to us that the industry will continue to be an essential element of their economies and energy security for many years to come.

Carbon Management

This would not be a twenty-first century thought piece without mentioning carbon footprint and carbon tax considerations. There have been many improvements in upstream operations to reduce the environmental impact. In some areas, flaring has become more widely restricted or penalized, facility specifications have become more carbon-conscious and industry standard maintenance activities have improved the detection of leakages. However, broadly speaking the carbon related taxes imposed on upstream operations are tied only to flaring or "scope one" emissions (GHG emissions that are released during the upstream operations) and relatively insignificant in the context of overall upstream finances. Furthermore, many of the countries with the most ambitious climate goals have simultaneously taken steps to facilitate ongoing investment in upstream oil and gas developments, as discussed in the previous section.

In the view of this observer, the lack of material carbon taxes applied directly to the upstream as well as fiscal concessions to encourage upstream investment while a government is simultaneously trying to achieve other climate goals is reasonable. Carbon taxes will be the most efficient means to wean economies off their reliance on hydrocarbons. However, the appropriate application for these taxes are not solely and directly related to upstream contracts and operations. Such taxes will need to capture scope one, two and three emissions across the entire value chain. Primarily taxing domestic upstream oil and gas production will simply make the upstream operating environment less competitive on a global scale and pressure investments and hydrocarbon production to relocate to potentially less carbon-conscious jurisdictions. Where and how to implement such taxes so that that all local and imported carbon derived products are taxed equitably through the value chain is a complex matter indeed, but for this discussion we note that we have not seen material carbon imposts incorporated into upstream contracts (outside direct emissions) and do not believe this to be the appropriate place for the bulk of what is needed in this domain.

This topic of course merits a much more thorough discussion and for this GaffneyCline is pleased to refer you to one of the many other publications by GaffneyCline experts in carbon management, carbon reporting and carbon capture.

Maturation of Basins

Though related to the following section, the maturation of basins over time requires the revisiting of Petroleum Contracts and fiscal terms due to changing perceptions of hydrocarbon prospectivity within basins and other implications. References to maturity in this context is not geological maturity but maturation in the technical understanding of the basin realized through exploration and development and references to prospectivity not only contemplate remaining hydrocarbons but also the cost environment when compared to other opportunities on a global scale.

Firstly, on a positive note, the ability to commercialize gas assets has unlocked new opportunities for many jurisdictions that did not contemplate such developments when originally structuring their Petroleum Contracts. Generally, commercializing natural gas is often more difficult and costly compared to liquids (primarily due to the potential high cost of market access) and thus, in theory, should merit a lower level of resource taxation (or Government Take). However, in some contracts globally this is not the case, often because legacy Petroleum Contracts assumed that natural gas would be a low cost by-product of a liquids development or did not envision a non-associated natural gas development at all. Even up to a decade ago, it may have been the case that a material non-associated gas discovery would mean the exploration campaign is a failure. Now the options to utilize and monetize natural gas developments are much greater and more widely understood. We have been a part of fiscal reviews initiated by governments to encourage gas developments as well as discussions where holders of older Petroleum Contracts with undefined or overly onerous terms for monetizing natural gas (often due to their parity with oil terms or that it must be provided freely to the Host Government) must approach the governing authority to discuss the potential of non-associated natural gas developments and the level of taxation they could commercially bear. The methods that governments have taken in order to enable natural gas developments have taken many forms:

- Many have implemented an entirely separate set of natural gas fiscal terms (for example standard onshore terms in Nigeria are some of the most strict globally with a 20% liquids royalty and 85% income tax but to enable gas developments Nigeria implements some of the most lenient natural gas terms globally with only a 7% Royalty and 30% income tax).
- Some have subsidized gas prices to augment the level of profitability associated to the Upstream operations or asset in question (examples include Argentina's temporary elevated gas price for unconventional developments, the gas price agreed for specific developments within Egypt and India or contractual linkages to liquids prices in jurisdictions such as Iraq).
- Others have a more comprehensive involvement in facilitating the development and financing of gas and LNG opportunities (such as Senegal and Mozambique).

With a less homogenous route to commercialization compared to historical liquids developments, non-associated gas developments can require an extensive and often time-consuming evaluation period, but accommodating and transparent discussions between oil companies and governing authorities can usually result in very fruitful opportunities for all those involved.

The next observable fiscal movement relates more directly to basin maturity. As a basin matures, the expectation of finding large new discoveries often dwindles. When perceived exploration potential reduces so does the interest in grand exploration campaigns. Confronted with reduced basin prospectivity, it may be appropriate to revisit fiscal terms or find ways of enabling historically sub-commercial developments. One clear example is the UK North Sea. Though some may argue there is still great potential, most appreciate that the interesting leads have largely been investigated. When faced with declining production, not only has the UK hydrocarbon specific tax been reduced from 32% at the beginning of the 2010s to 10% (and there is a much longer history too) the government also created a new entity to help facilitate maximizing the economic recovery of the UK North Sea. The implications of an aging basin and infrastructure will not be unique to the UK North Sea and countries should consider responses to this inevitability. Other methods of enabling older or commercially challenged opportunities is providing opportunity-specific fiscal concessions. Many jurisdictions have some sort of fiscal allowances for difficult, small or costly hydrocarbon developments, whether they be tax breaks, different profit splits or just progressive tax elements. Some relief to support the development of "marginal" opportunities has existed for a long time but recently we have seen an influx of entirely new Petroleum Contracts to facilitate such developments, often in the form of "Marginal Field" terms:

- In Angola, to help push the development of some assets the government can review the extent to which a specific asset is economically challenged and issue a Presidential Decree designating the discovery as a marginal, thereby giving it several fiscal concessions.

- Marginal fields in Nigeria have taken a different form - the government has carved out discoveries that lay within existing acreage but left undeveloped for many years and re-tendered the assets in a bidding round solely for Nigerian oil and gas companies with a much lower applicable royalty.
- India has approved various Discovered Small Field policies to help the “monetization of unmonetized discoveries” as the Ministry puts it.
- In 2020 Malaysia instituted new “Small Field Assets” PSCs, which have simplified and improved fiscal terms to the Contractor in order to enable the production of smaller fields.

It has been clear that taking proactive steps to facilitate development left otherwise unattended can lead to tangible benefits to the countries’ economies, and it is perhaps important to consider sooner rather than later as the world moves towards a less carbon-centric future.

Finally, in many jurisdictions the country’s first wave of hydrocarbon developments and Petroleum Contracts are approaching the end of the contractual life for the first time. License end brings a myriad of issues and opportunities. When developments approach the end of their contractual life (and there is no contractual right for an automatic extension), there is new leverage in the hands of host governments. It is not always in the interest of the host government to attempt to extract excessive rents or replace the current operator, which could lead to deterioration of the asset, but opportunity does abound with many countries using license extensions as an opportunity to move some working interest share into the hands of the National Oil Company or potentially transferring the asset in its entirety to the National Oil Company. Most importantly though, some older vintages of Petroleum Contracts or the laws governing petroleum operations do not sufficiently detail the mechanisms governing and funding abandonment and decommissioning. Contract extensions are a logical time to introduce industry standard decommissioning provisions, however in many jurisdictions this topic needs addressing with more urgency.

Global Learnings

While we always advise that no contract type is inherently better than another and that the same governance and incentives can be implemented irrespective of type, there are contractual aspects that are more associated with a specific contract type. Thus, some contract types are arguably more suitable for certain asset types or assets at different stages of their life. Some countries have a long history of implementing multiple different contract types. For example, Nigeria, realizing the different cost and operational environment of certain assets long ago, implemented a royalty based on water depth in the law; then introduced different Petroleum Sharing Contracts for Deep Water and Shallow Water; then implemented the aforementioned marginal field terms and is now nearing the finish line of a new overhaul (which may merit a separate article down the road). However, though there are examples stretching back many years, there has been an increasing trend of host governments starting to consider the option of utilizing different contract types for different assets. In this observer’s view, this flexibility was promulgated by the Mexican Energy Reform through the early 2010s, which emphasized the use of different contracts dependent on the asset type. Since then, we have seen numerous jurisdictions introduce new (and in some cases reintroduced old) contract types or at least enshrined in law the ability to consider such flexibility.

A final contractual element worth mentioning with a trend stretching back further than a couple decades is the inclusion of progressive tax elements. While they have been popular element for a very long time, the global understanding and benefits of progressive tax elements continues to improve and their implementation continues to expand. The flexibility of such elements, whether it be an R-Factor, production based tranches, price related fee or return-based adjustment are widely considered worthwhile. Such elements often lead towards higher levels of government revenues (on an undiscounted basis) for those governments that can focus on the long term as well as embed flexibility in the contract to account for potential changes in market conditions, allowing it to better weather the test of time (which also provides comfort to those deciding to invest in a long-term opportunity).

Ultimately, there is no perfect answer to choosing the fiscal levers used to extract value while encouraging investment, it’s not an exact science. Just like everything reliant on making future projections, whether it be a person buying a house, a company making investment decisions, or a government drafting hydrocarbon tax law, one must make decisions now with the information available, recognizing the uncertainty of the future. Thus, having a comprehensive understanding of what has worked in the past, the current industry standards and recent trends is essential in making such decisions.

GaffneyCline takes pride in having a global perspective on such topics and supporting our clients of all types and sizes. I am happy to refer you to one of GaffneyCline’s many experts or publications in the fields of carbon management, gas monetization, development planning, resource assessment or commercial advice or if you would like to discuss global petroleum fiscal regimes feel free to email me at Fred.Weltge@gaffneycline.com.