

Lebanon Petroleum Fiscal Regime: Guiding Principles

Dr Carole Nakhle, Director, Crystol Energy

Abstract

The Lebanese Ministry of Finance is currently reviewing the taxation system in view of establishing a specific fiscal regime for petroleum activities. Such regime needs to finely define the features of the oil and gas sector and set the main framework for profit sharing of the hydrocarbon wealth between the government and the investors, whose interests diverge more often than they converge.

The components of a fiscal regime are often misunderstood. Though the corporate income tax forms the system's corner stone, it remains one of numerous taxation and para-taxation tools that constitute the fiscal regime for petroleum activities in any country. Investors examine the regime in its totality, when assessing the investment attractiveness of a country.

In fact, fiscal regimes of petroleum activities have become highly sophisticated worldwide, sharing many common features that are difficult to classify according to a specific terminology, at least from an economic perspective. The fact remains that different fiscal regimes may lead to the same desired results in terms of restrictions or overall economic outcomes. The system design and thus consistency, including the interactions between the various fiscal and para-fiscal instruments, as well as the details concerning the bundle fiscal tools imposed are far more important elements than the type of fiscal regime that is chosen.

Opportunity

Delaying Lebanon's first ever offshore licensing round, once again, must have been frustrating to many officials and citizens, as well as to the pre-qualified companies. The consequences, however, may not be as disastrous as many fear. On the contrary, postponing the round from April to summer 2014 can be seen as an opportunity for Lebanon and its key ministries to revise and finalize all the necessary legislative and regulatory requirements for the establishment of a sustainable oil and gas sector.

It was the Petroleum Administration (PA) that cleverly took advantage of the government's resignation in May 2013 to revise the Exploration and Production Agreement (EPA) it devised and improve loopholes that existed in the original contract. Key ministries, such as the Ministry of Finance, are following suit and working hard on upgrading various relevant tax laws in order to capture the special features of this complex and large industry. This, understandably, is a challenging task. If the oil and gas sector is successfully established, it can dwarf any other sector that the Lebanese economy has witnessed. The Offshore Petroleum Resources Law, regulations and EPA which have been finalized are all crucial but not entirely sufficient to build a strong sector over the long term. Other laws, especially the income tax law, should also be modified to incorporate the distinct characteristics of the sector.

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The upstream petroleum fiscal regime is a key pillar in this process. It is the principal system for sharing potential hydrocarbon wealth between the government and investors, and is also the main tool that the former uses to achieve its objectives from the industry. These objectives, however, should first be clearly defined and in line with the country's broader energy and economic policies, which in turn need to be properly set. In Lebanon, all these remain rather ambiguous.

Government and investors

Government and oil companies are the principal players in the upstream sector of the petroleum industry, but their individual focus is one of competing rather than complementary objectives. Governments normally seek to generate high levels of take from oil and gas related activity while companies want to ensure an appropriate, predictable and sufficient level of profitability in their operations.

Investors have limited resources and typically have more opportunities than the financial and human resources required to develop them, so inevitably priorities will need to be established. A rational investor will allocate resources to those opportunities that offer the most attractive long-term returns at the highest capital efficiency.

A combination of commercial and non-commercial factors come into play in assessing the competitiveness and attractiveness of an oil and gas province. Investors seek to achieve reasonable returns at an acceptable level of risk. In assessing an opportunity, investors therefore compare the expenditures to be incurred with the potential rewards; the evaluation looks at factors such as geological potential, commercial prospect, political risks and, of course, the fiscal terms. The end result of this process permits opportunities to be ranked across the global portfolio.

Governments, especially in the early years of the exploitation of a basin, have a very strong objective to receive revenues as soon as production commences. Most governments, however, seek much more than tax revenues from the oil and gas sector, although revenue maximization remains the key objective for the state. These additional objectives include: establishing a national oil company (NOC); technology access and transfer; training and employment; domestic market supply obligations (DMO); development and use of local supply chain and maximum investment and infrastructure development.

Most of these factors result in an economic cost to the investors. For instance, maximizing local employment is a common and legitimate objective for governments. However, in the early years of a basin, the local infrastructure and logistics support are unlikely to exist, and government pressure to assist in their creation is likely to result in additional costs to the investor.

Both governments and oil companies want to secure 'fair' shares of the oil and gas proceeds. The big problem resides with the vagueness surrounding the subjective concept of 'fairness'. Since there is no objective yardstick for sharing economic wealth between the various interests involved in petroleum activity, controversy and tensions will always prevail between the investors and government.

It is important for the government to achieve a balance between maximizing revenues on the one hand and encouraging and sustaining investment in exploration and production on the other. The fiscal regime is the tool that government possesses to determine and alter that balance.

Fiscal Package

The design of the fiscal regime is a critical factor in shaping perceptions of an oil and gas basin's competitiveness. Often, however, there is a misunderstanding of what the regime encompasses. The corporate income tax is an important component but it is only one of several fiscal and quasi-fiscal instruments that together constitute a country's petroleum fiscal regime. It is the interaction of all these different instruments that potential investors evaluate when assessing the attractiveness of a country.

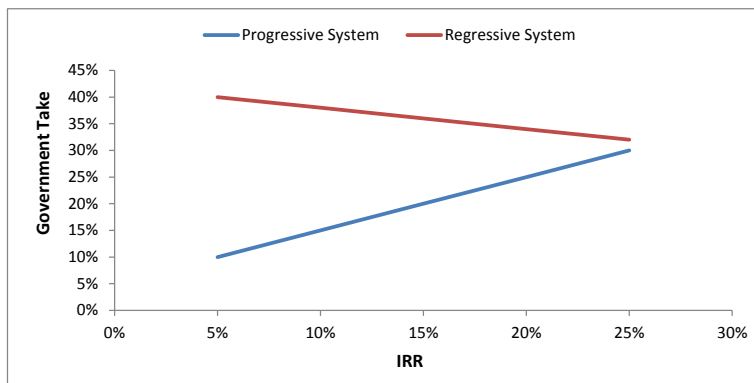
Practitioners in the field of upstream taxation are more familiar with the typical fiscal ingredients that make up the structure of most of the world's tax regimes, which include, royalty, resource rent tax, corporate tax, profit oil/gas and cost oil/gas. What is less familiar, however, is a wide range of commercial and regulatory obligations placed on investors, which, although in most circumstances are not labelled as taxes, are in effect just that in terms of their economic consequences. These obligations confer additional benefits to the state; they include: state participation; bonus; ring fencing; depreciation; DMO; capital gains tax which affect project's profitability directly.

For instance, today in the OECD countries, all sectors in the economy except the oil and gas sector are subject to an average income tax of 25 per cent, down from 33 per cent in 2000. In the oil and gas sector, however, the average government take – that is the total share of government revenues from a project's net cash flows - varies between 65 and 85 per cent.

The industry has special features. Oil and gas resources are non-renewables and state-owned with significant potential of economic rent, therefore providing the rationale behind higher government takes. The industry also faces substantial uncertainties all along the supply chain. Of central relevance are the uncertainties associated with petroleum geology, the specific characteristics of individual oil and gas fields and the investment returns. The costs of petroleum projects tend by their nature to be incurred up front and the time lags are considerable, often of many years and even decades, from the initial discovery of oil or gas reserves to the time of first production, which can then last for more than 30 years.

The design of fiscal regime should take into consideration all these features. Investors typically prefer regimes that impose less upfront burden and are more profit-linked - in other words 'progressive'. Instruments such as royalty, bonus, carried state participation, and low cost recovery ceiling, tend to lengthen payback and make the regime more regressive. However, the latter instruments allow the government to generate revenues as soon as production starts, unlike profit-related instruments. That is why a combination of several instruments is often used to satisfy both government and investors' objectives.

Figure 1: Progressive vs. Regressive Regime



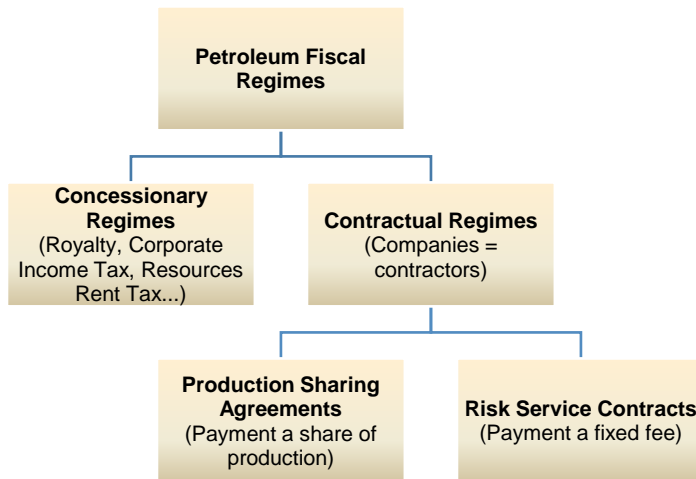
Concessionary and Contractual Regimes

Two types of fiscal regimes prevail in oil and gas exploration and production activities – concessionary systems and contractual systems.

The concessionary system originated at the very beginning of the petroleum industry (mid-1800s) and still predominates in OECD countries. The contractual system emerged a century later (mid-1950s), and has been typically favoured by developing countries. The UK, Australia, Canada, the US and Norway, for example, operate a concessionary regime, companies being entitled to the ownership of the oil extracted. By contrast, countries like Angola, Azerbaijan, Nigeria, and Iraq apply a contractual regime, whereby the government retains the ownership of the petroleum produced. Contractual regimes are widely spread among developing countries. Lebanon has opted for the contractual arrangement, which is also popular across the region.

Because modern concessionary regimes include various combinations of a royalty, an income tax and a resource rent tax, they are also known as ‘Royalty and Tax Systems (R&T)’. The basic features of the oil and gas concessionary regimes are similar, but the fiscal terms or ingredients vary considerably and are likely to evolve over time as the fields and basins mature.

Figure 2: Petroleum Fiscal Regimes



Under typical contractual systems, as the one found in Lebanon, the oil company is appointed by the government as a contractor for operations in a certain licence area. The oil company then carries out petroleum operations in accordance with the terms of the contract and operates at its own risk and expense, providing all the financing and technology required for the operation.

The parties agree that the contractor will meet the exploration and development costs in return for a share of production, or a cash fee for this service, if production is successful. If the company receives a share of production (after deduction of the government's share), the system is known as a Production Sharing Contract (PSC) – also called a production sharing agreement (PSA) – which is a binding commercial contract between an investor – the IOC – and a state (or NOC). Since the company is rewarded in physical barrels, it takes title to that share of petroleum extracted at the delivery point (export point from the contract area).

If the reward is a cash fee, the system is called service agreement, where, in the case of commercial production, the company is paid a fee (often subject to taxes) for its services without taking title to any petroleum extracted. The service agreement is the least popular; it is found in less than ten countries around the world.

Just like concessionary regimes, contractual regimes can be designed in many different ways, with terms varying both within and across basins. In their most basic form, they include: cost recovery, profit sharing, service fee, and income tax. It is also increasingly common to find royalty.

As mentioned earlier, under contractual arrangements, the investing company bears all the costs and risks of exploration and development. It has no right to be paid in the event that discovery and therefore development do not occur. In the case of a commercial discovery that moves forward to development, the company is allowed to recover the costs it has incurred and this is known as *cost recovery* or *cost oil/gas (cost petroleum)*.

Cost recovery is similar in concept to deductible expenses for tax purposes (including depreciation of capital assets) under the concessionary systems. Typically, it includes

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unrecovered costs carried over from previous years, operating expenditures, capital expenditures, abandonment costs and some investment incentives. Financing costs or interest expense is generally not a recoverable cost, although unrecovered costs can often be rolled forward with an uplift in lieu of interest or a permitted interest rate.

Typically, in any one year there is a fixed proportion of total production that investors can use to recover their costs. If costs exceed the cost recovery limit, the difference is carried forward for recovery in subsequent periods. The cost oil/gas limit usually ranges from 40 to 60 percent of gross revenue. A fixed ceiling on cost oil secures up-front revenues to the government as soon as production commences. Cost recovery limits can be at a specific rate or a variable one (biddable or negotiable). The more generous the limit is, the longer it takes for the government to realise its take. Low cost recovery limits, however, can negatively affect the development of marginal fields.

Under a PSC, the oil or gas that remains after the oil company has taken its cost oil/gas is usually termed *profit oil/gas*. The cost recovery ceiling ensures there is always a minimum quantity of profit oil/gas, which is divided between the host government and the company according to a pre-determined percentage agreed in the contract. The split can be constant, or on a scale linked to cumulative or daily production rates, or to achieved levels of project profitability (Rate of Return - ROR - or R-factors).

In Lebanon both the cost recovery ceiling and the profit sharing are biddable.

Under a service contract, since the contractor does not receive a share of production, terms such as profit oil are not appropriate, even though the arithmetic will often carve out a share of revenue in the same fashion that a PSC shares production.

Both profit oil/gas and the service fee can be subject to the corporate income tax. In some countries such as Cyprus, the government pays the contracting company's income tax from its share of profit oil; these are called 'pay on behalf' PSCs. Non-tax specialists tend to confuse this aspect with zero corporate tax rate.

Choice

Petroleum fiscal regimes have become very sophisticated, borrowing features from each other up to the point where the classification of a fiscal regime under a specific terminology has become more difficult, at least from an economics perspective. For example, in concessionary regimes, a royalty is imposed as compensation for the transfer of ownership of the oil produced – at least that is the theory. In practice, however, royalty is used to provide an early and relatively predictable flow of tax revenues. As a result, many PSCs around the world have a strong royalty component, even though it is not consistent with the legal nature of such arrangements, since governments retain full production ownership rights.

Also, many concessionary regimes, such as those found in the UK and Norway, have abolished the royalty in an attempt to encourage investment in the mature North Sea.

Today, there are more fiscal regimes than there are countries. Table 1 classifies the main oil and gas producing countries according to their fiscal regime. It should be noted, however, that one

country can have more than one fiscal structure under the same regime (e.g. the UK) or more than one regime (e.g. Libya).

Table 1: Fiscal Regimes across Countries

	Tax & Royalty Regimes	Production Sharing Regimes	Service Agreements
Africa	Chad; Democratic Rep of Congo; Gambia; Gabon; Ghana; Morocco; Namibia; Sierra Leone; Somalia; South Africa; Tunisia	Algeria; Angola; Cameroon; Congo-Brazzaville; Cote d'Ivoire; Egypt; Eq Guinea; Eritrea; Ethiopia; Gabon; Guinea Bissau; Guinea Bissau-Senegal JEZ; Kenya; Liberia; Libya; Madagascar; Mali; Mauritania; Mozambique; Niger; Nigeria; Sao Tome; Senegal; Sudan; Tanzania; Togo; Tunisia; Uganda; Zambia; Uganda	
40	11	29	
Asia Pacific	Australia; China; Japan; New Zealand; Pakistan (onshore); PNG; South Korea; Thailand	Bangladesh; Brunei; Cambodia; India; Indonesia; Laos; Malaysia; Mongolia; Myanmar; Nepal; Pakistan (offshore); Sri Lanka; Vietnam	Philippines
22	8	13	1
Europe	Austria; Bulgaria; Croatia (onshore); Denmark; France; Germany; Greece; Greenland; Hungary; Iceland; Ireland; Italy; Netherlands; Norway; Poland; Portugal; Romania; Spain; Turkey, UK	Albania; Croatia (offshore); Cyprus; Malta	
24	20	4	
FSU	Latvia; Kazakhstan; Russia; Ukraine	Azerbaijan; Georgia; Kazakhstan; Kyrgyzstan; Russia; Turkmenistan; Uzbekistan	
11	4	7	
Latin America	Argentina; Barbados; Bolivia; Brazil; Colombia; Ecuador; Falkland/Malvinas Islands; Peru	Aruba; Belize; Brazil; Cuba; Guatemala; Guyana; Honduras; Panama; Suriname; Trinidad & Tobago; Uruguay	Ecuador; Venezuela
20	7	11	2
Middle East	Neutral Zone; UAE; Israel; Qatar	Bahrain; Jordan; Oman; KRG; Syria; Lebanon; Qatar; Yemen	Iran; Iraq; Kuwait
15	4	8	3
North America	Canada; United States		Mexico
3	2		1
Total 134	56	72	6

Sound Assessment

Some question whether the choice of regime Lebanon made is the right one. In reality, the type of the regime is less relevant. Fiscal regimes can be made equivalent in terms of both control and overall economic impact, for given oil and gas prices. The design of the regime, the interactions of different fiscal and quasi fiscal instruments, the details related to the imposition of different instruments, among others, are by far more important.

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Furthermore, limiting the assessment of the effectiveness or strengths of the fiscal regime to the choice and rate of the major headline taxes is very restrictive. Several factors, such as fiscal reliefs and the process of calculating the tax base can lead to significant differences among fiscal packages, while different structures and regimes can produce the same results in terms of revenue and tax ‘take’.

Furthermore, while the overall government take is important, the timing of when tax instruments hit investors, and therefore affect their payback, is equally relevant. The conditions of the oil and gas region must also be kept in perspective. A high level of government take may not be justified in cases of high-risk exploration and high-cost development, or for those areas with remaining modest petroleum potential. High government takes are generally sustainable if the basin offers high volumetric potential and high returns, which is critical for large oil companies.

Other important features of the fiscal regime include its simplicity and stability. Simple regimes reduce the administrative burden. A tax regime that is simple to understand, implement and administer, is levied on a well-defined tax base. It increases transparency and reduces administrative burden, for both administrations and the taxpaying businesses. The more transparent the means by which the government obtains revenues, the better informed the investors and the less the scope for maladministration or administrative discretion.

Unstable fiscal regimes negatively affect the confidence of investors in government policy. Of course, fiscal regimes cannot be expected to be set in stone. Circumstances are constantly changing in any basin. A certain degree of flexibility needs to be allowed in any tax system if it is to respond to differing conditions, such as maturity, and to evolve as a result of major changes in the external environment. However if a tax system changes frequently and unpredictably, it may seriously affect future development projects since it increases political risk and reduces the value placed by investors on future income streams. It is recommended that the variation of taxes over project life can be minimized. The design of a progressive regime allows the system to respond automatically to changes in conditions, giving investors greater predictability. Emphasis on stability is equally important to governments. A tax system that has some level of predictability and reliability enables governments to know how much revenue will be collected and when. Stable government revenue clearly assists with reliable expenditure forecasting and budgeting. The issue of stability emphasises the need to get things right from the beginning to avoid unpopular changes.

The imposition of petroleum taxes and the involvement of international companies in oil and gas activity is a delicate matter which tends to be accompanied by intense political debate, where myths and political dogmas can overshadow economic principles. Building a successful oil and gas sector, however, requires an objective and comprehensive judgment.
