Host Governments and Oil Companies Relationship in Today's Market Conditions and Trends

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Crystol

Outline

- What affects host government – industry relationship?
- What can the industry do to minimise fiscal and political risk?
- Where next?

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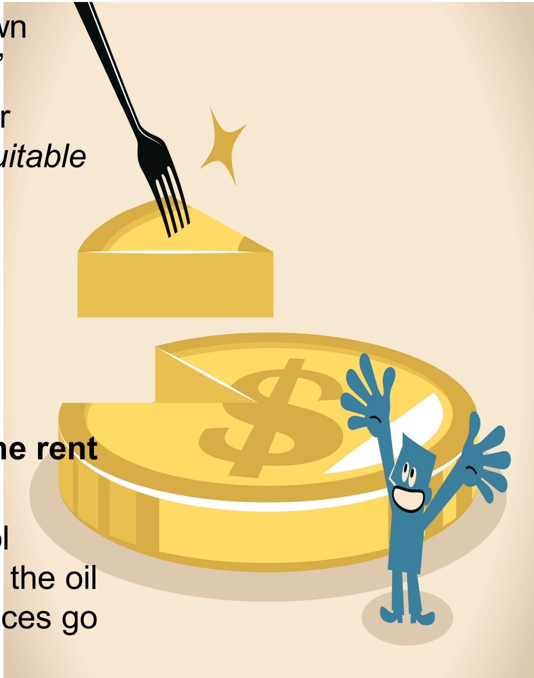
Inherent instability

- **Government fair share**
- Governor of Alaska: “Getting *fair* value for our known resource is the only way we can be self-sustaining”
- Liberia: “the fiscal regime shall create incentives for responsible investors while providing *a fair and equitable return* to” the country

- **But what is fair?**
- 50%-50%? 60%-40%? 70%-30%?

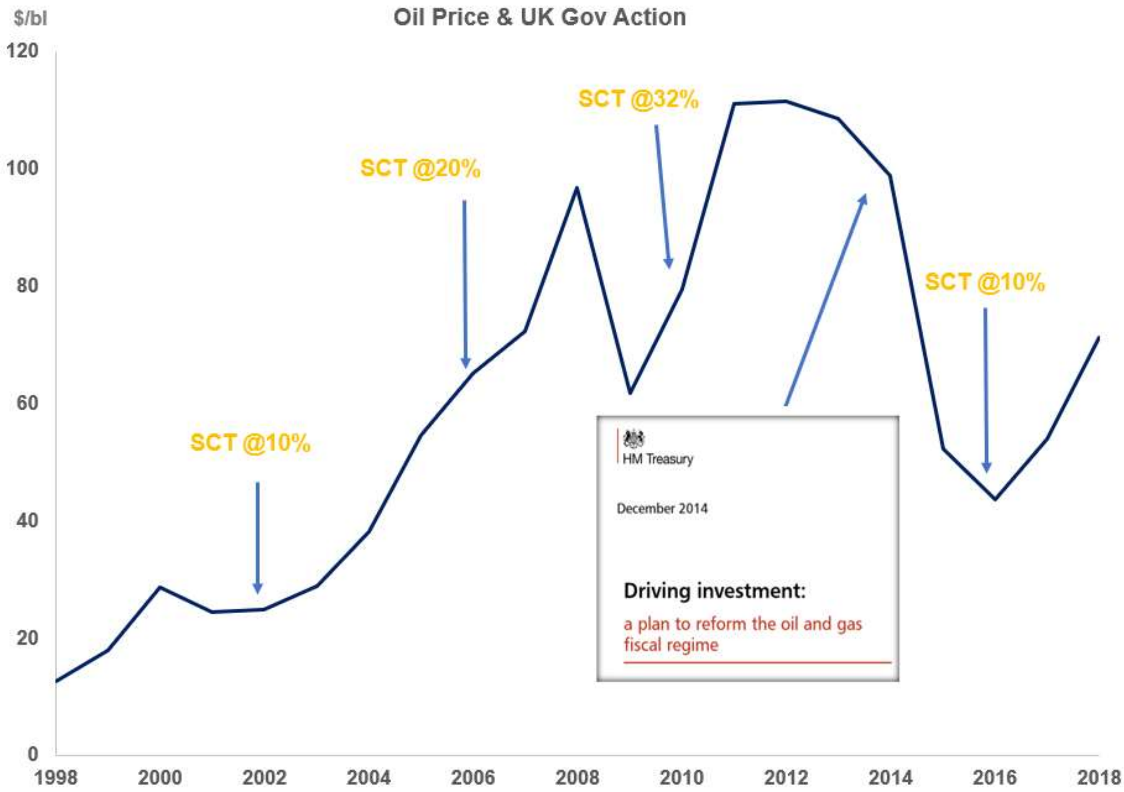
- **Dynamics of what constitutes a ‘fair share’ of the rent fundamentally unstable**
- A government share of 50% when oil price is 50$/bl suddenly becomes unfair for the government when the oil price jumps to 100$, and unfair to the industry if prices go down to 20$



Long list of factors that shape the relationship

- Oil price (most obvious)
- Investment trend
- Production life cycle
- Politics
- Regional effect
- Government finances
- Public interest
  - Energy transition

Chasing the oil price: the UK's swinging pendulum



Resource nationalism

- Government interventions, through direct exercise of discretionary powers or ownership of resource, (theoretically) to increase the benefit of a nation as a whole

- *"All around the world, from Algeria to China, governments are changing the terms of investment in oil and gas, on the ground that they are not receiving their fair share of the profits. For critics of capitalism, last year's surge in oil and gas prices seemed to present a long-awaited chance to shift the global balance of power away from corporate behemoths and the governments that are closest to them",* Energy and Nationalism, *The Economist*, March 8, 2007

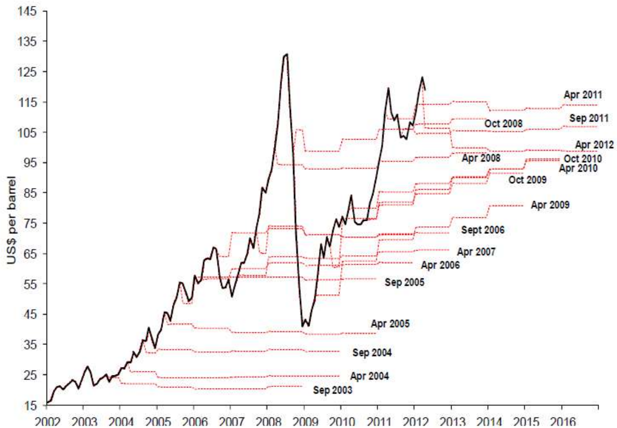
- **Varied reaction:**
  - Increases in existing tax rates
  - Application of new taxes
  - Increasing NOC share
  - Expropriation of assets

Resource nationalism: Cyclical

- 2009: “Resource nationalism on the decline”:
  - “*Governments the world over now need investment more than ever… They know capital is in short supply the world over, they know they are* ***competing*** *with other countries for capital*” Former CEO of BG, Frank Chapman, 2009

- Financial Times “2012: the year of resource nationalism?
  - Argentina’s YPF

Problem with chasing oil price



EIA Oil Price Scenarios, 2015

IMF 2012, EIA 2015

Oil markets have entered a new phase

EIA 2020

How will governments react?

Trump to Meet With Oil CEOs About Helping Industry

Investment level

- Rising investment:
  - Governments may believe they can introduce a tax increase with little pain

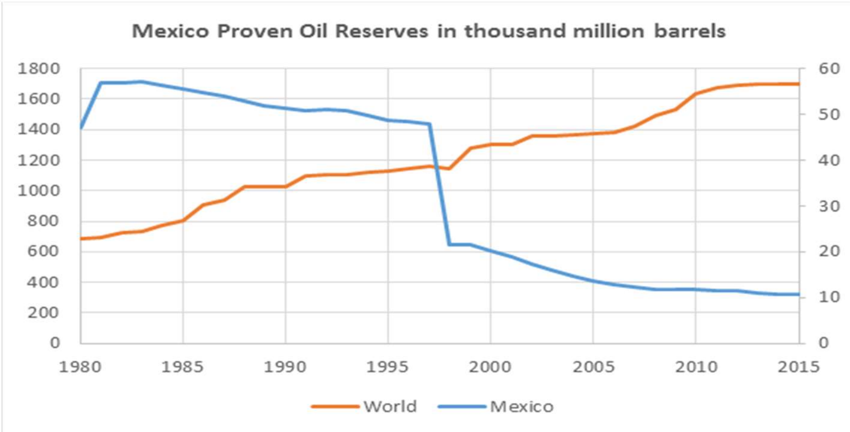
- Obsolescence bargain:
  - From government perspective, strong incentive to introduce/increase taxes when significant investment sunken
  - Once committed, the investor has lost his leverage and bargaining power

- Unexpected declines in investment may trigger the opposite response

Major reforms during high prices

- **Algeria:**
  - Revision of hydrocarbon law in 2013
  - Incentives introduced

- **Mexico:**
  - Energy reforms announced in 2013



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Production life cycle

- Beginning of the life of a basin:
  - Government provides attractive tax regime to encourage investment and kick-start activity

- Once commercial discoveries made:
  - Bargaining power shifts in favour of host country

- When basin matures:
  - Tax regime revisited as unit costs rise and discovered volumes decline

Production life cycle: Israel

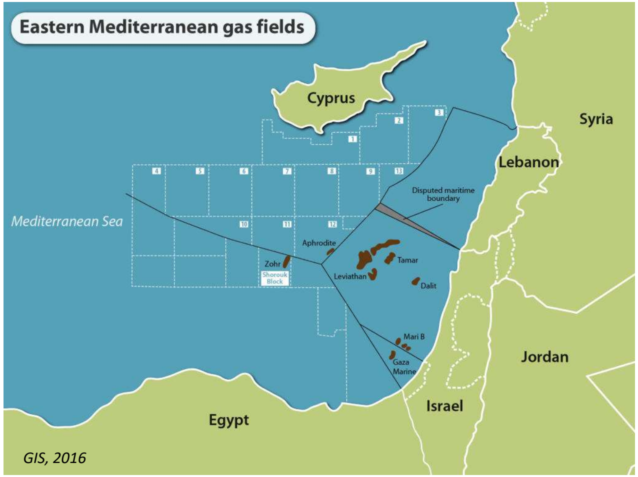
- Petroleum fiscal regime formulated in 1952 and largely unchanged until 2011

- Old regime: Government take 30%

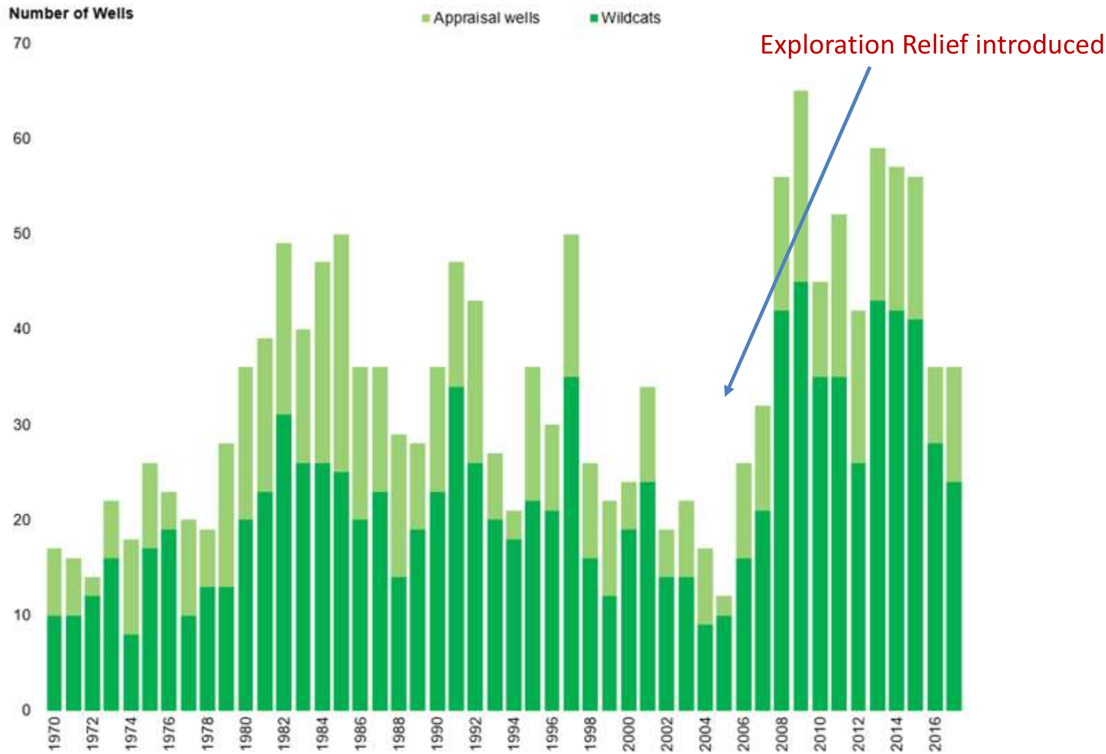
- 1999: 1st offshore gas discovery (Noa field), followed by other discoveries

- 2010: "*the current system does not properly reflect the public's ownership of its natural resources*" (Sheshinski Committee)

- In 2011, fiscal regime tightened
  - Government take 50%-60%



Norwegian experience



NPD 2018

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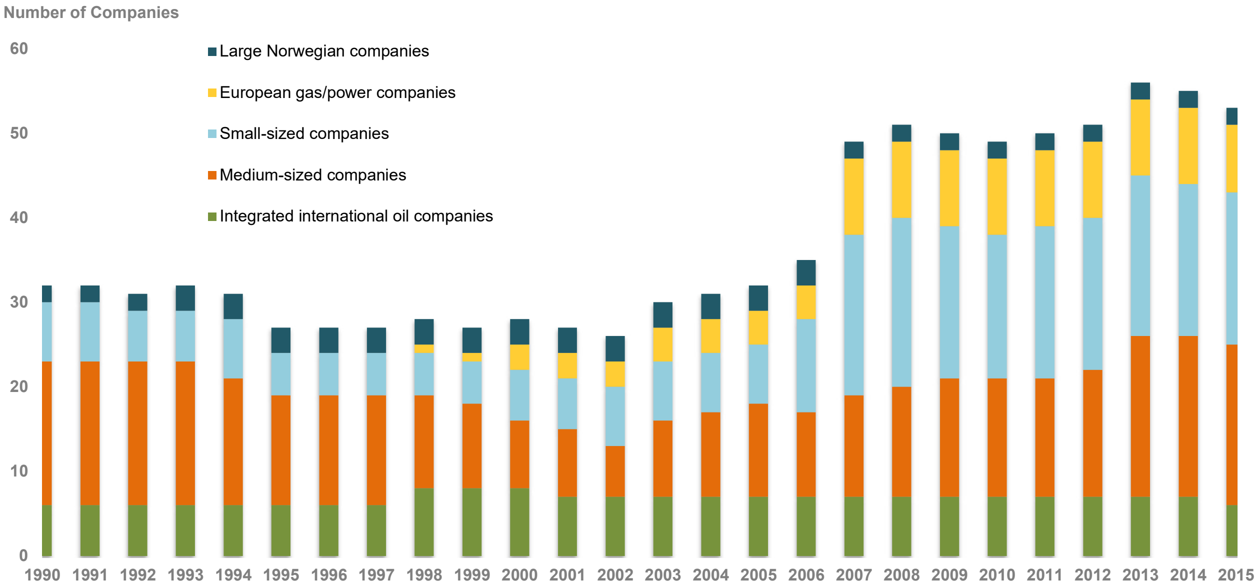


NPD 2016

Project delays and cost overruns

- Tensions if a project, critical to the nation in terms of revenue generation and finances for host government, delayed/suffers cost overruns
- Impact may fall disproportionately on government and defer revenues
- Likely to cause material budgetary problems for state finances if the proceeds have already been committed to public programmes
- Typical response:
  - An increase in taxes to keep expected government revenue stream intact
- Kashagan project in Kazakhstan

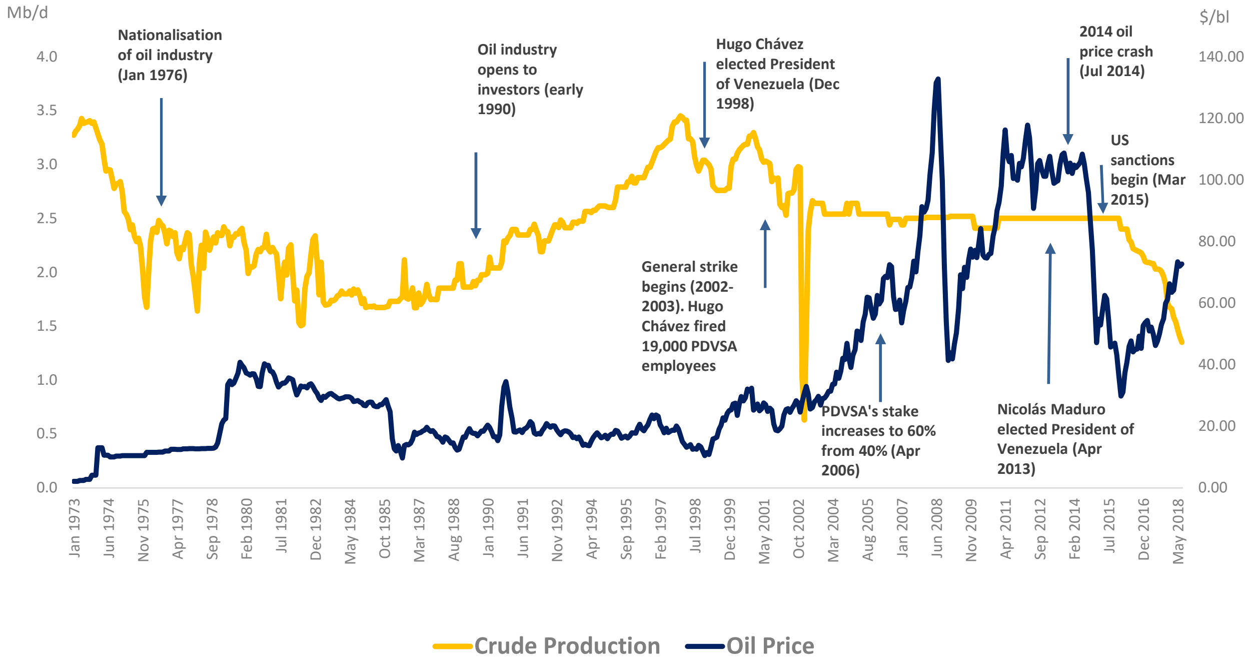
Political factors

- **Deteriorating government finances**
- When governments look for new sources of revenue, oil/gas sector easier target than many others

- **Regional trend and neighbourhood effect**
- Governments benchmark the competitiveness of their tax regimes with countries with geographic proximity
- A tax increase in one country can be followed by copycat increases in its neighbours

- **Changes in political conditions**
- A system designed by previous administration likely to be reviewed by a successor with a different political persuasion or ideology

The Venezuelan experience



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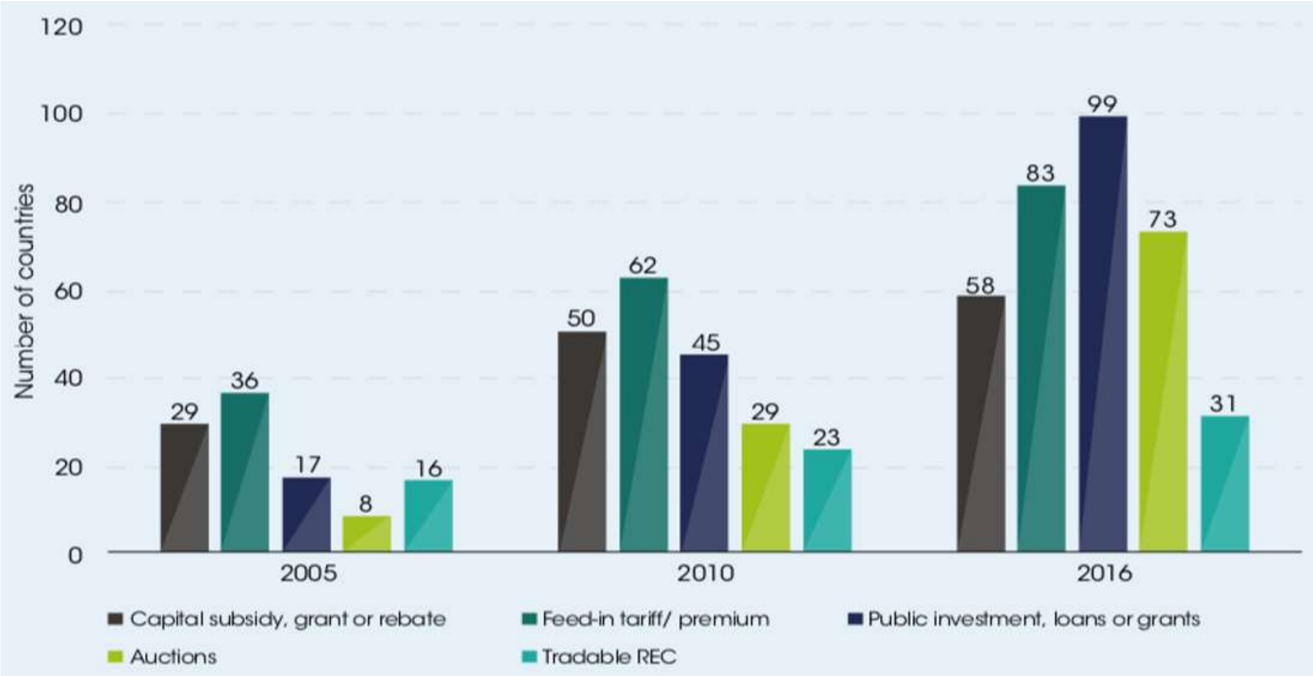
Number of countries adopting renewable energy policies



Irena 2018

Fiscal cost unclear

- **Germany:**
  - The burden placed on households by the renewable energy surcharge would amount to "**only around one euro per month, the price of a scoop of ice cream**", Former Green Environment Minister Jürgen Trittin, 2004
  - "The costs of the Energiewende and of the transformation of our energy supply could add **up to around one trillion euros by the end of the 2030s**", Federal Minister for Economic Affairs and Energy, Peter Altmaier, 2013

- **UK:**
  - Fuel duties represent around 4% of government total tax receipts of GBP 690 bn (US$893bn)
  - Whereas, a buyer of a Tesla vehicle will benefit from the 'Plug-in Grant', which is a purchase subsidy of up to £4,500 deducted from the purchase price, in addition to various taxes and charges exemptions

- **Norway:**
  - Tax revenues from petroleum activities more than US$ 5.2bn yearly

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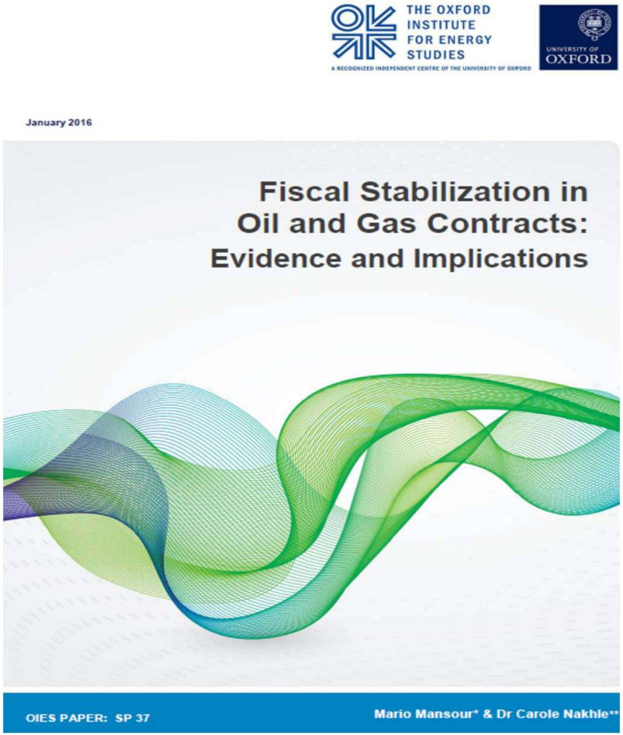
Stabilisation clauses

- **Lock in the contract terms for contract duration**
- Cover a broad range of host country laws
  - labour; environment; tax
- Fiscal stability clauses (FSCs) deal exclusively with taxes and royalties
  - May cover some or all taxes and fees



https://www.oxfordenergy.org/publications/fiscal-stabilization-in-oil-and-gas-contracts-evidence-and-implications/

Why do governments offer stabilisation clause?

- Feature of developing countries

- To compensate for the perception of higher political/regulatory risk
  - Especially when combined with higher geological risk
  - Psychological boost to reduce investors' risk premium
  - Superior to tax exemptions and tax holidays

- Tax competition

- Offered by governments in weak bargaining position

Too much faith in contractual stabilisation?

- Effectiveness questionable:
  - In countries which lack administrative capability to enforce FSCs
  - Where government policy, investment laws and judiciary lack credibility
    - More complex to enforce

- Contractual devices alone not sufficient for managing risks
  - Oil/gas contracts are inherently incomplete
  - Impossible to perfectly predict all states of nature in the future and account for them in the contract

- Reinforced by:
  - Competitive and progressive fiscal systems
  - Inclusion of broad stakeholder base

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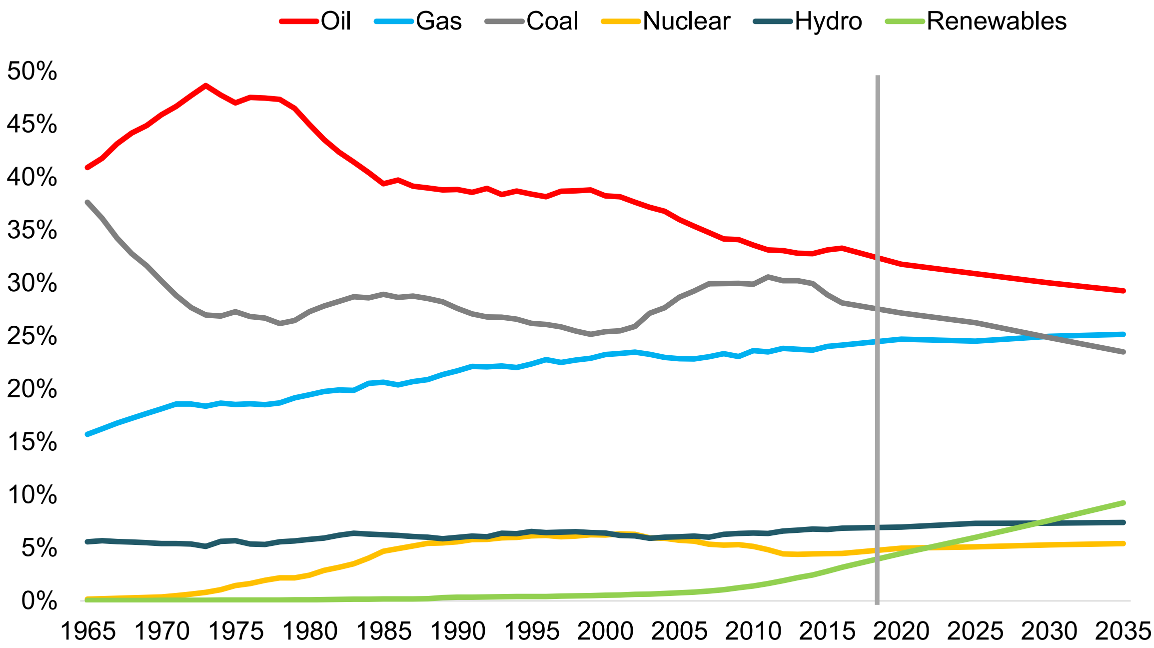
World primary energy outlook



BP 2019

Movement across the spectrum to continue, but…

- **Same old dynamics but new fundamental forces at work:**

- **Peak oil demand:**
  - Shrinking market
    - Stronger competition for capital between producers

- **A successful energy transition will limit supply in countries aggressively participating in Paris agreement**
  - IOCs' and some NOCs crowded out
  - The more successful the transition is, the more it will benefit some NOCs
  - New dynamics and a different market structure
    - Competition defined by politics; economics matter less
    - Much more difficult to forecast

Thank you!

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