

### **Depreciation bonus as a first step towards optimization of oil and gas taxation**

18 September the government passed a decision to grant a depreciation bonus of 30% to all enterprises including those operating in the oil and gas sector. It means that the taxable basis will be reduced by a third. In our opinion, although this measure is utterly important and necessary, not enough attention has been given to it.

It appears that, reducing oil and gas taxes, Russia can benefit from the global financial crisis. Also, if Russia's authorities consistently optimize energy taxation, there could appear a new 'growth point', that is the gas processing industry.

At present, independent gas-extracting companies are not able to work efficiently due to a restricted access to Russia's gas transportation network. They do not sell volatile hydrocarbons but burn them in flares, thus not only hurting the economy but also damaging ecology. However, as far as by 2011, such companies will be required to process 95% of associated petroleum gas, otherwise they will have to pay large fines. It is highly probable that measures like this will help fight inefficient use of this valuable energy source. However, the question of how producers can ship extracted gas remains unanswered so far.

Independent producers should not only be concerned with developing of gas fields, construction of processing facilities must be in the focus of attention, too. Many small businesses simply lack funds for that. Whether or not a credit line can be opened to finance a project depends on how quickly investments are expected to return (with some projects, the payback period can be too long). So gas-processing companies have three options: they can burn gas and pay enormous fines and, perhaps, closed; or build processing facilities; or sell the business. Every next owner will face the same difficulties, so a gas field can be re-sold several times and the industry will not see any technological development.

The decision to grant a depreciation bonus will likely stimulate technological development of the processing industry and use of alternative processing techniques because not-taxable amounts directly depend on the cost of equipment that companies buy. There are many natural gas-extracting enterprises, therefore it is not enough to only educe heavy fractions (C5+) because remaining light ends (mostly methane) are too sizeable. In this connection, companies will consider production of methanol, engine fuel and other products that would require utilization of extracted resources in whole.

The fact that authorities have tackled the problem of oil and gas taxation is highly positive. However, they should admit that depreciation bonus alone might be not enough to settle the issue.

Another measure to reduce the taxes is giving enterprises tax holidays. Their duration can be determined based on the term of starting industrial exploitation of a field and the term of putting into operation a processing facility. Thus, a tax holiday can last as much as 6.5 years. Obviously, to prevent unwanted tax exemptions, companies will be required to submit documents confirming their plans. Besides, state bodies can check the validity of submitted papers at any moment by inquiring relevant information from companies that are or will be participating in the project.

Creating a differentiated taxation system can also be an efficient measure. This approach can be used in respect of enterprises that add value, i.e. convert mineral resources into end products (for instance, into engine fuel). In this case, the total amount of taxes (oil and gas extraction tax plus excises) can be cut down, especially if produced commodities are not sold outside a given area. This activity can be seen as supporting fuel independence which is especially important for remote areas where gasoline prices are extremely high compared to personal incomes.

From a holistic point of view, customs payments can be re-considered, too. If there is a confirmation that a given type of equipment is not produced in Russia, such equipment can be exempt from customs fee when imported to Russia.

Optimizing the industry taxation, the state creates a new 'growth point' which will bring about a number of positive effects.

- Even if a tax holiday is given, after a gas field and a processing facility are put into operation, capital inflows into budgets of all levels are guaranteed.
- Enhancement of a region's socio-economic environment (construction, infrastructure, jobs).
- Gas flaring reduction will raise the industry efficiency and help decrease the amount of lost profit and volumes of harmful emissions.
- Technological development and diversification will raise the sector's competitive power, added value will be increased by processing companies; this will have a direct impact on the national economy.

We underline once again that measures aimed at taxation optimization and their results are an outline and have not been studied in detail. However, it is clear that there is an urgent need in working out a set of measure to optimize taxation of small-sized oil and gas companies.

By Kirill Lebedev