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*Professional paper*

## The Petroleum Fiscal Regime and Oil Company Status

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**Key words:** Transition, Exploration contract, State legislature, Fiscal terms, Licence.

### Abstract

In the foreseeable future the Republic of Croatia will be included in the market economy as a consequence of recent widespread social changes. The oil industry will also be affected by these changes, inevitably becoming a part of the wider market, and it will have to adjust its business practice accordingly.

To facilitate the inevitable transition of INA into a modern and profitable company, capable of survival in the market, it is necessary to create favourable business environments for possible economic growth and development. As a first step towards this goal it is necessary for the state of Croatia to adjust its legal system to be compatible with those prevailing in the market economy.

There are several different legal approaches in world practice specific for a particular country, and one has to take them into consideration while creating legal relations in the oil industry in Croatia. Here a comparison is made between the present legal status in Croatia and some of the others abroad. An optimal solution is proposed from the viewpoint of the company dealing with the oil industry.

### 1. INTRODUCTION

Oil production in Croatia is declining remarkably as a consequence of a lower replacement rate of reserves. The natural decline of remaining reserves as a consequence of oil depletion, is partly slowed down by the introduction of secondary recovery methods. However, the best replacement of reserves are new discoveries, because only on newly discovered pools can various technological applications give optimal results using human and technological resources.

Lengthy discussions have already taken place in the company as to the reasons for the delay of reserve replacement, whether it was the inefficiency of exploration, the delayed introduction of new exploration technologies (modern seismic equipment, informatics, 3D seismic and so on) or maybe insistence of intensive exploration in mature basins where major discoveries of new reserves cannot be expected. WHITE & GEHMAN (1979) investigated the remaining potential of mature basins, and showed that after the first discoveries in a given basin, larger fields are then discovered

quickly, but any remaining fields are more numerous but with less reserves. Analysis of the company's successful discoveries produces the same scenario. The assessment of the cause of decay of successfulness in exploration will enable the right strategic decisions to be made. The earlier prevailing opinion of INA was that increased accomplishment of the company would be achieved by improved technology and better expertise. Although these factors are relevant in the oil industry, the natural conditions of the area where the technology and knowledge are applied are even more important. In the Panonian Basin, there is a real possibility of finding new reserves, examination of remaining potential reserves indicates that it is not possible to find sufficient quantities of new reserves to replace the reserves decline. There has been no change in strategy required to look for new exploration opportunities.

Such a change must now occur under less than perfect conditions during a recession in the oil industry and after a war. The present status of the oil market strongly influences the potential entrance of foreign investors into oil exploration in Croatia. Since restructuring of the oil industry in Croatia has not yet taken place, and the government controls both natural resources and INA, (the only oil producer in the country, state owned), there is an opportunity to reshape the oil business so that it is compatible to other oil producing countries.

More investment is now required for prospects abroad and foreign investors must be attracted to the Croatian oil industry. This requires Croatia to develop a clear legislative system and become competent in current world practice, thus providing the stable operational conditions attractive to such investors. The aim of the paper is to compare the Croatian legal system as applied to the oil industry with the legislature in countries where we have some experience. These are not only countries where we have participated in exploration, either as an operator or as a partner. Confidentiality restricts this analysis to generalities, precluding disclosure of detailed information.

### 2. THE ROLE OF THE STATE

The fiscal regime is one of the most important factors in creating a business environment together with political and natural factors. A fiscal regime is a collec-

tion of conditions which a host country demands an oil company to fulfill in exchange for the right to undertake exploration and production of oil and gas in a limited area of its territory.

The precise nature of these conditions depends on many factors, of which the following are some of the most important:

- prospectivity of the exploration area;
- political risk in the country;
- competitiveness of the oil industry compared to other industries;
- macro economic policy of the country;
- general status of development of the country.

Depending on the assessment of the above factors, a host country will create its fiscal policy, and prescribe under which conditions it will temporarily give exploration rights on part of its territory. It is important that the above factors are objectively assessed and balanced with fiscal measures, i.e. the fiscal regime must be such that exploration projects are sufficiently attractive for potential investors (or comparable with others available on the market). It also must protect the interest of the host country, in other words it must enable the country to participate advantageously in future production.

The host country can claim its share in different ways, directly or through an agency, or through a national oil company by:

- royalty;
- production sharing;
- profit sharing;
- income taxes;
- profit taxes;
- additional taxes (export quotas etc.);
- bonus payments.

The country legally defines, most often by a Petroleum Law, the basic terms which are applied to the whole country. Some of the above parameters are negotiable, and they are usually stipulated in the bidding for an exploration area. The negotiations are held between an oil company and the government representative (government agency, national oil company and sometimes ministry for natural resources). It is important that once agreed contracts are unchanged during the whole life of the project, as this provides security. In many cases the law is changed successively depending on changes of the country's policy or prospectivity of exploration area, but once signed agreements, remain empowered until the end of the project.

### 3. TYPES OF THE AGREEMENTS IN THE EXPLORATION AND PRODUCTION OF OIL AND GAS

The types of agreements can be divided into two main groups:

- Royalty/Tax Agreements or Concession Agreements
- Production Sharing Agreements or Contracts

**Royalty/Tax Agreements or Concession Agreements** are such agreements where the government or country transfers the title of mineral resources to the company, and the company is subject to tax and royalty payments. This kind of agreements is becoming obsolete, and more rarely used.

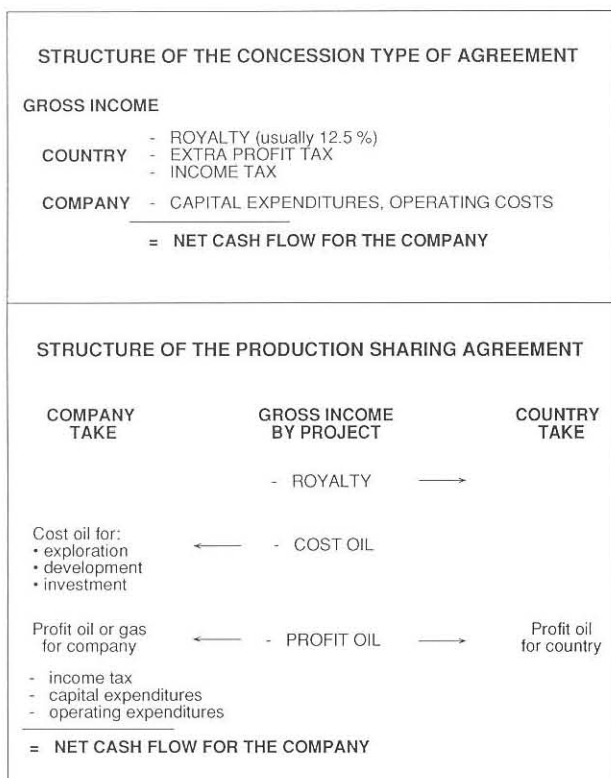
**Production Sharing Agreements** - the great majority of current agreements in the countries that are major oil producers, are production sharing agreements. A basic difference between this type of agreement and a concession agreement is ownership of mineral resources. In this type of agreement the government retains the ownership of minerals, while the oil company invests money in exploration, development and surface facilities taking the risk. The oil company on the other hand is allowed a certain percentage of oil or gas for cost recovery (cost oil) and for profit (profit oil). All equipment and objects included in the agreement become the ownership of the host country immediately after signing the agreement or after starting production. Heavy service equipment for drilling and well operations are excluded. The company has a right to cost recovery for that purpose. There are many additional details in different agreements which, for example, specify the right to interests on invested capital, amortization, rate of cost recovery and others.

Besides production sharing agreements there are variants when the host country through its agency or national company forms a joint company for exploration and production financing, taking a certain percentage of working interest, i.e. joint venture agreements. Such a company is subject to all the legal regulations in the host country.

Along with these basic items which define the relationship between the owner of the mineral resources and a foreign company, (sometimes referred to as the contractor), the agreement contains additional contents including a work program, entitlement to the data coordinates of the area covered by the agreement, relinquishment after a certain phase, duration of the agreement, reporting of financial issues etc. At the same time the obligations of the country or a national oil company are defined, including access to data, assistance during agreement implementation, nomination of authorised representatives, project supervision, cost control etc.

The agreement usually defines a myriad of other details which enable operations to be carried out without any misunderstanding, but they don't determine the attractiveness of a country for investment in oil and gas exploration and production.

Some countries, especially those in transition from a socialist to capitalist system, treat their own oil companies differently to foreign ones. Some countries, e.g. Italy, in past years, had exploration areas exclusively reserved for AGIP, Albania for Albpetrol, etc. The national oil companies of some other countries also act



as operators, as well as taking care of the organisation and supervision of exploration and production of foreign companies, e.g. Sonatrach in Algeria, NOC in Libya, and to some extent SONANGOL in Angola.

#### 4. CROATIAN LEGISLATURE

The rights and obligations of a company and an individual person engaged with exploration are determined by the Mining Law, published in "Narodne novine", Zagreb, on May 26, 1995. According to this Law, all organic and inorganic mineral resources are

considered mineral resources owned by the Republic of Croatia. The law also defines all technical and legal details related to obtaining licenses for oil and gas exploration and production, but less so to business activities themselves. One of the provisions of the Mining Law is the obligation to use a part of any income (minimum 3%) earned from the sale of minerals, for mineral reserves exploration. A mineral royalty (compensation for the exploration of mineral resources) is 2.5%, and represents the revenue of the Republic of Croatia which is assigned to municipalities or cities. The Croatian Government establishes the amount of compensation/royalty percentage. Also "If a mining company or an individual person owns the discovered reserves of mineral resources classified as A+B categories for exploration, they are not obligated to allocate funds for exploration in the following 25 years." This does not reveal what kind of production is involved.

A "Licence for exploration or exploitation of mineral resources can be granted to a company located in the Republic of Croatia and registered for the performance of such activities (in further text mining company) and to citizens which are engaged in this economic activity with their own work registered in the Republic of Croatia (in further text individual entrepreneur)". A licence for oil and gas exploration and exploitation is granted by the Government of the Republic of Croatia. Licences cannot be transferred to another physical or legal person without permission of the authority who granted them and cannot be the subject of bankruptcy or liquidation.

The law imposes limits on certain exploration rights in a given area.

Besides these provisions which have been slightly elaborated, the law defines the right to mineral resources exploitation. It is granted to a mining company or an individual entrepreneur if they have earlier performed exploration activities in this area.

SOME COUNTRIES WITH CONCESSION TYPE AGREEMENTS	SOME COUNTRIES WITH PRODUCTION SHARING AGREEMENTS
ABU DHABI	ALBANIA
ALGERIA (until 1991)	ALGERIA (after 1991)
ARGENTINA (1990)	ANGOLA
FRANCE	EGYPT (since 1986)
IRELAND	GABON
MOROCCO	INDIA
NORWAY	INDONESIA
PAKISTAN	LIBYA
THAILAND	MALESIA
TUNISIA (special type)	MALTA
UK	NIGERIA
	SYRIA
	TURKMENISTAN
	VIETNAM
	UZBEKISTAN
	JEMEN

Furthermore, the law provides for the manner, conditions and rights concerning mineral resources exploitation, managing and recording of reserves, necessary technical documentation, land-registry of exploration areas and exploitation fields, the required professional and other capacities of workers, safety measures, supervision and finally, penalty measures.

Several articles of the law anticipate the preparation of several by-laws such as: "By-law on the contents of an annual program of exploration, the procedure of the application for exploration licence, and the details of the licensing procedure", "By-law on the contents of the application for exploitation licence" etc. The by-law on the contents of an annual program of exploration, the procedure of the application for exploration licence, and contents of the reports on performed exploration activities, determines the terms for submittal of annual reports and plans, contents of the application for licence, etc. Furthermore, this by-law establishes some very important parameters related to exploration rights, such as licence duration/validity (3 years), work program, exploration area, and deviation from the undertaken obligations of work program during application for exploration rights. There is no time duration of production rights.

Art. no. 15 of the above by-law is very interesting and reads as follows:

The size of exploration area is determined according to/based on:

- planned exploration activities on the basis of which reserves of mineral resources can be established belonging to at least category C;
- (the amount of) available financial funds;
- obligation to carry out planned exploration activities at the latest within a period set in the art. 13, line 1 of this by-law.

It can be observed from the above that the legislator who prescribed the regulations and obligations related to oil and gas exploration and production, did not take into account world practice existing in the oil industry. Most countries have a special law covering this branch of industry owing to the fact that the oil industry is significantly different from all others, although it can be agreed that it is most similar to other mining activities.

If we wish to summarize the fiscal regime in the Republic of Croatia according to the Mining Law, it could be expressed as:

#### **Company obligation:**

- to offer a minimal work program;
- to provide necessary financial funds (there is no indication of how it is going to be checked);
- to provide adequate means of production;
- company alone proposes the area of their interest.

Once the company has been granted an exploration licence, their obligation is to:

- perform operations envisaged in the annual work program;
- report on plan realisation;
- report on invested funds;
- make a final report;
- continually report on the discovery of new hydrocarbon reserves (which is prescribed by a totally different by-law).

Once there is a discovery of hydrocarbon reserves, the company is obligated to:

- provide a licence for the field exploitation;
- the exploitation licence is granted conditionally by technological and personnel suitability;
- there is no time limit for the licence;
- company status towards the state is not defined.

Although the Mining Law does not explicitly state it, the total revenue should be divided in the following way:

- TOTAL REVENUE (FROM OIL AND GAS PRODUCTION AND SALE)
- 2.5% OF TOTAL REVENUE FOR THE STATE, LOCAL SELF-MANAGEMENT
- 3% OF TOTAL REVENUE FOR THE PURPOSE OF EXPLORATION OF UNDISCOVERED RESERVES
- CAPITAL EXPENDITURE
- OPERATING EXPENDITURE
- TAX INCOME 25%
- = NET CASH FLOW

Table 1 shows the comparison between the state's take and the oil company's take in different types of agreements.

It is obvious that an oil company's take in Croatia, for one field yielding 10 mil. tons, and under the aforementioned conditions, is significantly higher than in any other country, the contracts of which we were able to use for comparison. Consequently, a conclusion can be drawn that our present legal system insufficiently protects the state interests in the case of foreign companies entering directly into agreement with the state.

## **5. CONCLUSION**

According to the above analysis we may conclude that the existent legislature in the Republic of Croatia is not transparent enough, and that it cannot serve as the basis for signing one of the known types of contract with the clearly defined rights and obligations of the state on one side, and the oil company on the other. Practically, the state cannot protect its interest without the strong presence of a national oil company, which need not always be acceptable to a foreign company as a potential investor.

<b>Croatian Tax Regime</b>	
Compulsory Exploration Expenditures	3%
Optional Exploration Expenditures	32%
Capital Expenditures	20%
Operating Expenditures	10%
Royalty (2.5% of Revenue)	3%
Tax (35% of Profit)	11%
Net Profit	21%
<b>Structure of Typical Concession Type Tax Regime</b>	
Compulsory Exploration Expenditures	3%
Optional Exploration Expenditures	32%
Capital Expenditures	20%
Operating Expenditures	12%
Royalty (8-16% of Revenue)	8%
Tax (35-50% of Profit)	9%
Net Profit	16%
<b>Structure of Typical Production Sharing Contract</b>	
Cost Oil (30-80%)	50%
State Profit Oil (40-90%)	40%
Company Profit Oil (10-60%)	10%

Table 1 Comparison of different types of tax regimes.

The law does not define how to obtain an exploration area. There is no bidding procedure whereby the best offers could be selected. The law determines the percentage of total revenue for investment in exploration, but it is not agreed on how much should be invested in an exploration area. The time limit for investment in exploration, which is not determined by

the law, but by a by-law, is only 3 years - for the cycle of geology-geophysics, exploration and drilling. The law does not define the period of production rights. In other words, according to the current law, the state cannot get an income from oil adequate to the practice in other oil and gas producing countries, but at the same time it does not clearly guarantee to an oil company any safety of long term investment.

Considering the interest of a Croatian oil company undertaking exploration abroad, it is obvious that a dollar invested in Croatia brings considerably more return than a dollar invested abroad, with the same geological and political risk, the same reserves and the same work conditions. Under the same contractual conditions the percentage of net present value belonging to a company deducted from net present value per project, ranges from 1:3 to 1:2. Consequently, the probability of oil discovery or the size of an exploration area abroad, should be in a reverse relationship in favour of the international project if we want to invest in this project.

In order to formulate a decision on selecting a project for investment, one should carefully compare all available projects using available economic and technical parameters. One should choose the projects that indicate the fastest return on investment and the highest profit.

## 6. REFERENCE

- WHITE, D.A. & GEHMAN, M. (1979): Methods of estimating oil and gas resources.- AAPG Bulletin, 63/12, 2183-2192.

