

HIGH PRICES ARE NOT ENOUGH



As oil prices reach new highs, stable and investor-friendly legislation is more important than ever for investment in the oil industry. Common 'rules of the game' are needed. But this is not the responsibility of market forces but of governments argues Dr. Andrei A. Konoplyanik, Deputy Secretary General, Energy Charter Secretariat

Recently, a lot of publications, including lengthy analytical papers, on oil-price-related issues have appeared in world media – first in specialised press, as a result of the unprecedented (in nominal terms) rise of oil prices which has almost reached 50\$/bbl mark. But just as the whole ocean is reflected in a single drop of water, the major problems sometimes might be addressed in number of short comments. The very fundamental issue of oil investments was most recently debated in the Financial Times in series of letters to the editor and in an editorial comment on 26 September 2004 entitled 'Broken Drills'.

Robert Mabro, President, Oxford Institute of Energy Studies (Letters, 30 August), correctly indicated that the drastic reduction in the amount of surplus capacity today is one of main reasons for the recent rise in oil prices. He proposed that governments should design, negotiate and enforce a burden-sharing agreement on the financing of new production capacities, which are needed for a healthy market.

Paul Stevens, Professor of Petroleum Policy and Economics, Centre for Energy, Petroleum, Mineral Law and Policy, University of Dundee, in a letter dated 1 September 2004, was no less correct when he mentioned, as a related dimension, that today's market failure and short-termism might be the major reason for under-investments into new oil capacities, since under current financial strategies of international oil companies funds should be returned to shareholders (and thus be invested into building new capacities) if a corporation's returns cannot outperform the stock market.

For a number of years (at least since 1999) the oil market has faced a strong backward trend, when spot prices have been exceeding forward ones (with brief exception at end of 2001/start of 2002) which de-stimulated exploration – despite general price growth. The lack of new additions in the Greenfield areas (ie, of new giant, and thus relatively less expensive fields) has meant that the cost of adding new oil and gas reserves has increased

almost by half since 1997. Rising finding and development (F&D) costs and increasing basin maturity have also increased by almost half the amount of maintenance capital spending required to offset production declines in already producing oil and gas fields (according to Merrill Lynch calculations). According to our joint (with Moscow-based Energy and Investment Policy and Project Financing Development Foundation - ENIP&PF) calculations on the basis of BP data, almost one third of generalised oil price rise in last five years was due to F&D costs. So, the costs and thus demand for capital has increased, but the adequate capital supply – not.

Some analysts have concluded that the current rise in oil costs is a 'structural' and thus irreversible one and that it proves their thesis that since now oil price fluctuations have moved from the \$20 range to \$30-40 range. In my view, this cost increase has a cyclical origin and an investment-related background. To again diminish the costs (or at least to slow their growth) and thus

transfer the upward pressure on oil prices into a downward one (or soften it), adequate investment stimuli need to be provided to the oil business. These signals need to come from the States.

In their long-term investment decisions, oil companies have generally been considering as reasonable a 13-15% rate of return. Today's stock market has been providing opportunities for receiving higher returns and in shorter periods. So, according to Stevens, one can see incentives for the oil companies' shareholders to speculate on the stock market rather than invest into new oil capacities, ie, stimuli for outflow of their capital, which might otherwise be potentially available for investments into new projects, from productive to speculative areas of business activities. That might create under-supply of investments, in conditions when the demand for such investments has been steadily growing.

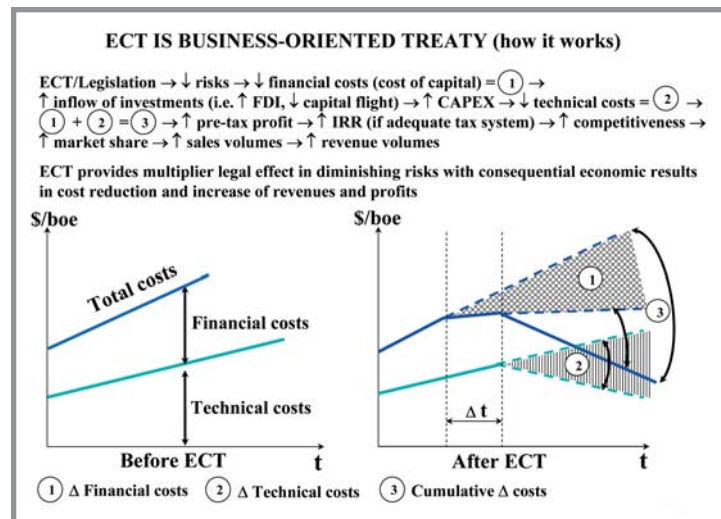
The oil crises of the '70s were overcome because, as Stevens has rightly noted, in the past the self-correcting market mechanism established a direct link between the growth in oil price and the increased ability and willingness of producers to invest, thereby raising the quantity supplied, and which limits the shelf life of any period of high prices. Since then the unit (\$/bbl of new capacity) and absolute values of investments needed to put the worldwide oil producing capacities to the levels considered to be 'safe' for the market (which means an extra 4-7% of 'surplus' capacities to the level of current production) have grown significantly.

The higher the levels of production, the greater the need for replacements for fields that producing but declining. That by itself provides a strong demand for investments in the mature regions since large fields there are usually replaced by a bigger number of smaller fields. And this is in an industry which has huge (compared to other sectors) unit capital value of individual projects (measured sometimes in dozens billions of dollars) and the presence of risks, related to upstream oil and gas investment decisions, which are not in place in non-mineral industries (for example, geological risks). Globalisation trends, increased interdependence of the energy producers and consumers, demands for diversification of supplies related to the increasing role of energy security issues, expansion of exploration further outside OPEC countries, increasing role of debt-financing instruments in the financing of new projects – all these and other related issues have increased the importance of risk component (in addition to geological risks) in the investment decision-making process of the oil companies over the past two decades. The role of risk component in the oil price has grown.

One can say that the oil price increase in recent years was even higher than the growth in both costs and risks. But, for long-term investment decisions based on a 'project financing' approach (ie, when the revenues from each individual project needs to recoup the investment made to develop and operate that project),

the level of the price on the stock exchange is not enough by itself.

Firstly, to approve investment decisions for new projects, the companies who will develop such projects and the banks and institutional investors who will provide external capital, need a stable and predictable flow of future revenues. This is why, in a very volatile oil price market,



they usually use very modest future price estimates – even now in the 18-20 \$/bbl range, maybe slightly more, but definitely not in the 30-40-50 \$/bbl range. Whatever arguments could be provided to prove that prices have once and for all moved into 30-40 \$/bbl range (which I strongly doubt myself), it will be the oil companies and banks which will be the last to incorporate the fact into their long-term investment decisions.

In some cases, Governments themselves have provided clear signals to oil business as to which price levels they should consider →

normal for long-term investment purposes. Thus, according to recent amendments to the RF Tax Code, when the oil export price exceeds 25\$/bbl (which is the middle of current OPEC 'price corridor'), 90% of the incremental oil export revenues would be taken from the company to the state budget through the new formula of customs export duty. By this action, the Russian Government has clearly indicated that it considers prices higher than 25 \$/bbl as abnormal, and will therefore generate windfall profits from oil companies, and should not be used in feasibility studies on the development of new investment projects.

Secondly, it is not the spot/futures price by itself that matters (ie, not the current spot/futures quotations of WTI at NYMEX or Brent at IPE), but rather the after-tax price of particular oils in particular producing countries during the particular project life. That means that the desired tax regime needs to be investor-friendly, stable and transparent. The stability of the after-tax prices in countries where major new investments are to be made – or, in broader terms, the stability of the investment regime – is an even more important issue for such investments than the current level of spot/futures prices.

In the case of Russia, the oil investment regime that has been established since 2002 by the introduction of a new oil taxation regime based on flat-rated "NDPI" ("nalog na dobychu poleznykh iskopaemykh" or mineral resource production tax) has become transparent but not investor-friendly for Greenfield developments and for non-integrated (small- and medium-sized) oil companies, which have usually been developing few upstream projects and have not been using, contrary to their vertically-integrated 'bigger sisters', the mechanism of 'transfer pricing' which was the major aim of

the implementation of flat-rate NDPI taxation in Russia. NDPI has solved the problem of transfer pricing, but has de-stimulated oil investments in new projects. Regular changes in the tax collection mechanism within the licensing regime, including the introduction and recent upgrading of the NDPI take, shows that Russia still lacks stability in its oil investment regime. The regime based on PSA (production-sharing agreements), which existed in parallel to licensing one from early 1996, and which provided much needed stability for investors through the whole project life-time, was last year marginalized.

Thirdly, with the market going global, projects have become international. They are developed by international consortiums, include cross-border transportation and require international supplies of goods and services for project implementation, ie, they include states and companies with different jurisdictions and legal systems. The number of risks has expanded significantly – to their number related to one country one need to add the number of risks related to other countries involved in the international project. And the same risks in different countries will be different due to different domestic legislations. In order to minimise the risks related to such international (cross-border) projects, which have been increasing both in number and in cumulative value of investments, a common set of rules of the game, related to energy investments and trade, are needed. That is the most effective way to effectively diminish the non-commercial risks related to energy projects. And it is a task not for the market forces, but for the governments.

Since 1991, fifty-one Eurasian states, including all countries of the expanding EU, Eastern Europe, and the former USSR have been party to the Energy Charter

process and have been developing the common 'rules of the game' in the evolving Eurasian energy market, ie, the common legally binding rules based on a 'minimum standard' for the investment, trade, transit, energy efficiency and dispute settlement in energy within the territories and for investors of the member-states. Since 1998 the Energy Charter Treaty has been an integral part of international law system though five ECT member states have not yet ratified the Treaty (Russia being among them). So the instrument to stimulate energy investments is already there (see Fig. 1 on how it works). We just need to more to implement effectively existing opportunities which are already provided for the international energy community while further improving on them for the mutual benefit of the people of our member states. After all, surely, that is the very reason why energy is produced for. **rir**