Oil royalties and the rule of law
(or how the Romanian State experiences a drop in self esteem)

Laurenţiu Pachiu, Energy Policy Group

October 20, 2015

A good deal of the political and media environment in Romania continues to promote or to dwell in confusion when it comes to the Romanian state's gain from petroleum activities, popularly known as „the regime of oil royalties".

So far nobody has managed to identify a logical, legal and economic reasoning, a true "substantiation note" of the public interest based on which the initiatives to revise the tax system applicable to oil companies are promoted.

The most rumored idea is that "the current royalties expired on December 31st, 2014 therefore a new royalties system must be enacted" and naturally, the quotas of these royalties must be higher. It remains to be seen what the applicable legislation will provide in Romania ("as rule of law").

The alleged normative deed in supporting the campaign to amend the framework for the collection of state revenues resulted from petroleum activities is Law No. 555/2004 regarding several measures on the privatization of Petrom - S.A. Bucharest National Petroleum Company, entered into force on December 9th, 2004. Article 10 of this law provides at para. 2 as follows:

> *„Until December 31st 2014, except as otherwise provided by the laws or regulations generally applicable in the European Union which become applicable in Romania, the taxation regime enforceable on the company's (Petrom) and its subsidiaries' exploration and production activities shall not become, regardless of the form, more onerous for the company inclusively by the increase in the rates of the applicable taxes or by the introduction of new taxes regarding exploration and production."*

Paragraph 4 of the same article provides as follows: „*The provisions of para. (1), (2) and (3) shall be enforced during the entire term in which such are applicable to the company and to the other companies undertaking petroleum and natural gas exploration and production activities in Romania*."

Firstly, what needs to be clarified is that "taxation regime" consists of all taxes and charges enforceable on the petroleum companies conducting exploration and production activities, except for royalties which cannot be assimilated to taxes, such having a legal nature rather assimilated to rents.

The legal text mentioned above cannot be interpreted in the sense that on December 31, 2014 the taxation regime enforceable on petroleum companies in Romania would have „expired" and the petroleum activities would not be subject to tax regulation. The body of law in question provides a guarantee that the tax system enforceable upon enactment of the law in question shall not be amended, **at least** until closing date, so as to be detrimental to petroleum operators. Also, it may not be claimed that once a passed deadline there would be an obligation or need to review the fiscal system in question or impose new taxes and fees.

However, one cannot help but wonder whether the politicians, advocates of the increase in the taxation applicable to petroleum companies and the Romanian governments since 2004 until present have complied with the obligation not to amend the fiscal framework until December 31st, 2014.

To the detriment of their credibility, the answer is no. The introduction of the 60% tax on additional income obtained as a result of the deregulation of the prices in the natural gas sector by Ordinance No. 7/2013, that is to say in the period of the fiscal guarantees rendered by Law No. 555/2004 is a proof of hypocrisy in the Romanian petroleum sector regulatory policy.

As regards royalties, Art. 15 of the law in question provides as follows:

> *„(1) For a 10 years term as of completion, the following shall be maintained: the percentage level, the base level and the manner of computing the royalties owed by the company as per the individual concession agreements concluded by such, applicable upon enforcement of this law.*
>
> *(2) Until December 31st, 2014, the provisions of para. (1) shall be applied, upon request, to all title holders of individual concession agreements in the field of exploration and operation of petroleum and natural gas deposits, concluded with the NAMR."*

These provisions must be understood in terms of a legal guarantee and not towards maintaining the level of royalties until a deadline after which such "expires" and must be, willy nilly, amended. And if we were to accept the royalties "expiration" theory, how could we explain that after the 10 years the operators continued to pay royalties and the

state still collected the money. By the mere fact that royalties are valid based on concession agreements, during the term of such agreements. Moreover, for the rest of the petroleum concession holders, others than Petrom, the law provides at para. 2 the option, not the obligation of such, to be granted the legal guarantee in question. And if the royalties in Petrom's case are owed "as per the individual concession agreements concluded", wouldn't the approval of Petrom to amend such after 10 years, be necessary as for any other agreement?

Therefore, the "royalties" did not "expire". Such legal provisions were intended as to reflect the international standards in the field of (attracting and securing) long term foreign investments in capital intensive industries such as mining, infrastructure, utilities or strategic project financing. Several specialists speak of a self standing international system of laws, namely *lex petrolea*.

The Romanian legislation adopted this international practice in the petroleum field so as at any given moment over the past 25 years such was based on the principle of stabilization in petroleum concession agreements as seen in the below:

Art. 1 of Emergency Ordinance No. 160/1999 on establishing several measures for incentivizing the business of petroleum agreement title holders and the subcontractors of such conducting petroleum operations in marine blocks including areas with depths exceeding 100 meters:

> *„Petroleum agreement title holders and the subcontractors of such conducting petroleum operations in marine blocks including areas with waters exceeding 100 m in depth, shall benefit from the following measures for incentivizing the activity:*
>
> *a) during the performance of the petroleum agreement the fiscal regulations existing upon execution of such shall be applicable;"*

Art. 5 of Law No. 66/1992 on granting incentives to attract foreign capital in natural gas and petroleum deposits production:

> *"The incentives to be granted to foreign investors according to the present law shall be established for each agreement, during the entire term of the agreement which cannot exceed 30 years."*

Petroleum Law No. 134/1995:

> *"Art. 13: The provisions of the petroleum agreement shall remain valid during the entire term of such, under the conditions existing upon conclusion.*

Art. 42: The provisions of the petroleum agreements concluded prior to the enforcement of this law and approved by the Government shall remain valid as per the conditions under which such were concluded over their entire term."

Petroleum Law No. 238/2004:

„Art. 61 (1): The provisions of the petroleum agreements approved by the Government shall remain valid over the entire term of such, under the conditions in which such were concluded."

It could be inferred that the principle of legislative stabilization in terms of petroleum concessions is expressly enshrined in the Romanian law. In terms of the same international practice supporting foreign investments, the large majority if not all petroleum concessions concluded by the Romanian state include stabilization clauses.

The stabilization clauses are intensely used in agreements between the state and private investors, regulating the issue of legislative changes during the performance of the agreement. From the state's perspective, the stabilization clause is likely to draw foreign investments and technology transfer providing such with a guarantee that the legal framework is well balanced. In terms of private investors, the rationale behind this provision is to obtain guarantees against the risk that the state's unilateral action (through the enactment of laws or of subsequent policies) affects the contractual balance and the investment related conditions.

In practice, the stabilization clauses are of the following types: (i) *freeze* clauses by which the legal framework existing upon conclusion of the concession is "frozen" during the entire term of the project, (ii) clauses ensuring the economic contractual balance stipulating a flexible negotiation framework between the investor and the state for the purpose of adapting the agreement and maintaining the contractual balance related to new legislative amendments and (iii) hybrid clauses, which are a combination of the first two.

The international arbitration practice (ICSID) acknowledges the legal and mandatory nature of such stabilization clauses as part of the international law and as expression of the *pacta sunt servanda* principles (the agreement has the force of law between the parties) and of the good faith performance of the contractual obligations. The stabilization clauses should not be understood as affecting the capacity to exercise state sovereignty for example, by adopting normative deeds. The stabilization clauses however establish the state's obligation to act in good faith and, in case the clause is not observed, to grant compensation to the investor (see cases *Liamco v Libya*, *Aminoil v*

Kuwait, *Revere Copper v OPIC*). In the case *Parkerings v Lithuania* the arbitration court held as follows:

> *„It is each State's undeniable right and privilege to exercise its sovereign legislative power. Any State has the right to enact, modify or cancel a law at its own discretion. Save for the existence of an agreement, in the form of a stabilization clause or otherwise, there is nothing objectionable about the amendment brought to the regulatory framework existing at the time an investor made its investment. As a matter of fact, any businessman or investor knows that laws will evolve over time. What is prohibited however is for a State to act unfairly, unreasonably or inequitably in the exercise of its legislative power. "*

In another case regarding the existence of a tax stabilization clause, *Burlington v Ecuador*, the arbitration court held as follows:

> *„in the event of an amendment in the taxation system or in the case of an introduction or removal of several taxes that have not been provided in the agreement (the agreement with the investor), and which impact contract economy, a correction factor will be enforced on the production sharing percentages so as to absorb increments or reductions of the taxation level."*

Also, the Supreme Court in Estonia ruled, in December 2013, upon the unconstitutionality of a legislative amendment of the Estonian government in 2011 related to the increase of taxes for mineral resources extraction prior to the expiration of the stabilization period provided by the existing legislation. The law enacted in 2009 provided until 2015 a 5 years tax stabilization period for mineral resources extraction.

The international practice provides countless examples when the regime changes in petroleum royalties was only implemented for new concessions therefore complying with the stabilization of existing concessions (for example USA, the offshore federal concessions, Ireland, New Zealand, South Africa, Greece, Canada-Newfoundland).

Although contract stabilization should be observed, in the event taxes were anyway adopted in the upstream sector negatively impacting petroleum concession title holders, it would be necessary to implement contractual solutions to re-establish the financial balance of concessions. An example in this respect would be Albania where Transatlantic Petroleum is undergoing discussions with the Albanian government with a view to counteract the negative impact of a tax on mineral resources extraction.

Any failure to comply with the tax regime stabilization for existing concessions and the imposition of an unfavorable royalty/tax regime for investments has adverse

consequences on the country in question on medium and long term, since it leads to a drop in investment or deterrence of new investments and potential disputes with the affected operators. An example in this respect is Ukraine which negatively changed the regime of royalties for existing concessions, which resulted in a significant drop in investments and disputes with operators (ex. JKX Oil & Gas).

As regards the international treaties on investment protection which establish fair, non discriminatory treatment obligations in the duty of the Romanian state as regards investors as well as obligations to comply with the agreements concluded with such, these are topics that I addressed in previous articles and that I shall no longer revert to.

What is worth keeping in mind is that when the Romanian state has the clear and reasonable intention to reconsider the taxation and royalty system applicable in the petroleum sector, such will have to take into account the following:

- Own legislation on stabilization in petroleum concession agreements;
- The concession agreements concluded which contain stabilization clauses;
- Bilateral treaties for investment protection;

The imposition of a new taxation and royalties system in the petroleum field shall definitely entail the liability of the Romanian state. The negative effects in terms of the trust of investors in the Romanian investment environment will also be significant. The potential "exit" of petroleum operators following the negative impact of the new taxation framework will turn Romania's "import dependency" into a seasonal joke.

It is downright hilarious that an amendment of the tax and royalty system applicable to existing concession would provide the legal option for petroleum concession holders to consider that the amendment is not applicable to them (we are basically facing a hybrid stabilization clause), under Government Emergency Ordinance No. 54/2006 regarding the concession regime of assets in public property, and namely of Article 54:

„(1) The contractual relations between the concession grantor and concession holder are based on the principle of financial balance of concession between the rights granted to the concession holder and the obligations imposed on such.

(2) The concession holder shall not have the obligation to incur the extension of its duties related to the performance of its obligations in the event such extension arises as a result of:

a) a measure ordered by a public authority;"

Therefore, running the risk to breach the own legislation, the contractual obligations undertaken by the petroleum concession agreements and the obligations arising from international treaties, the Romanian state would give rise to a situation by which its new tax measures would have no outcome for the current petroleum operators.

We hereby consider that complying with the Romanian Constitution, namely with article 56 para. (2) providing that the legal system related to double taxation must ensure the fair distribution of tax burdens", involves the observance of the following principles when it comes to defining any additional tax on profit ("ISP") to upstream operators:

1. ISP can be worst case scenario enforced only to that part of the profit which represents extraordinary revenues exceeding the normal returns in the industry, in the event such profits exist.

   The enforcement of the ISP on the share of the profit which represents average returns for this industry conflicts with the Constitution which provides a fair double taxation of taxpayers in all sectors with the same share of tax on profit.

   The international practice is aware of the following instances ensuring that the ISP is only enforced on such extraordinary profits:

- Immediate deduction upon registration with the accounting records of the exploration costs, including those capitalized in terms of accountancy;
- Immediate deduction of investment costs upon registration with the accounting records;
- Granting additional deduction or tax credits for the ISP calculation base;
- Indexing losses for the ISP.

   In this respect what is worth mentioning is the decision of the Italian Constitutional Court dated February 2015 which raised the unconstitutionality of an additional tax on the profit of companies in the energy sector. The arguments of the Court strictly referred to the fact that such additional tax is only to be enforced on the entire profit instead of being enforced only to the share of the profits which represents extraordinary income as compared to the normal profitability level for such industry.

2. In the event that the ISP will also be enforced on the existing concessions, disregarding the stabilization of such, in order to ensure compliance with the fairness principle, that the taxable profits earned starting with the enforcement

date of the ISP are to be determined by the same rules, regardless of such being earned prior to or after entry into force of the ISP.

We estimate that a potential establishment of several conditions more favorable for new investments in terms of the ISP calculation (e.g. a more rapid deduction or higher additional deduction) would be unconstitutional meaning that it would discriminate investors which made investments until the date of entry into force of the ISP as compared to new investors.

3. In the event that the future regime will keep both the ISP and the royalties, we hereby consider that royalties must be offset from the ISP by a tax credit mechanism (or the ISP shall be deducted from royalties) to avoid a double or even triple taxation of operators considering the tax on profit applicable to all taxpayers.

   In most jurisdictions with ISP regime no royalties are enforced or such have a lower share or are deducted from the ISP owed.

The rational and legal solution would be for Romania to engage in transparent, well argued and direct discussions with petroleum companies in order to find solutions to the benefit of both parties (and not by the so-called "public debate" over a draft law which, as we all know, has become a superficial and purely formal exercise). In other words, although Romanian petroleum concessions include *freeze* stabilization clauses, the Romanian government must prove common sense and vision and pursue the mechanism specific to certain "economic stabilization" clauses.

Also, the Romanian government must reflect upon its long term administrative and political capacity, considering that it is very likely to end up implementing various legal regimes according to the legislation based on which the petroleum concessions were concluded. Establishing new taxes and royalties at this time to amend them in a few years depending on the political and electoral struggles or on the lack of capacity at administrative level will destroy the credibility of the investment environment in Romania.

Going further in this hazardous, superficial and political approach of the "royalties" issue, by breaching own legislation and several contractual obligations undertaken, the state puts its self esteem at risk.