Analysis of the specific fiscal regime applied to the oil and natural gas sector in Romania

October 2022

Context

The accelerated increase in natural gas and electricity prices starting in the second semester of 2021, with a significant impact on inflation, has led to a number of intervention and consumer support measures across the member states of the European Union (EU).

In Romania, the intervention measures started with Government Emergency Ordinance (GEO) no. 118/2021, to establish a compensation scheme for the consumption of electricity and natural gas for the cold season of 2021–2022, and the law approving it. That was followed by GEO no. 27/2022, GEO no. 106/2022 and, last but not least, GEO no. 119/2022. It should be noted that Romania had already had a specific taxation system in place for the oil and gas sector (e.g. additional taxes, petroleum royalties) for many years. Under that system, this sector's profits are subject to an effective tax rate higher than the corporate income tax rate of 16%.

Electricity prices started to rise due to a combination of factors, with the most important being the high price of natural gas used for producing electricity.

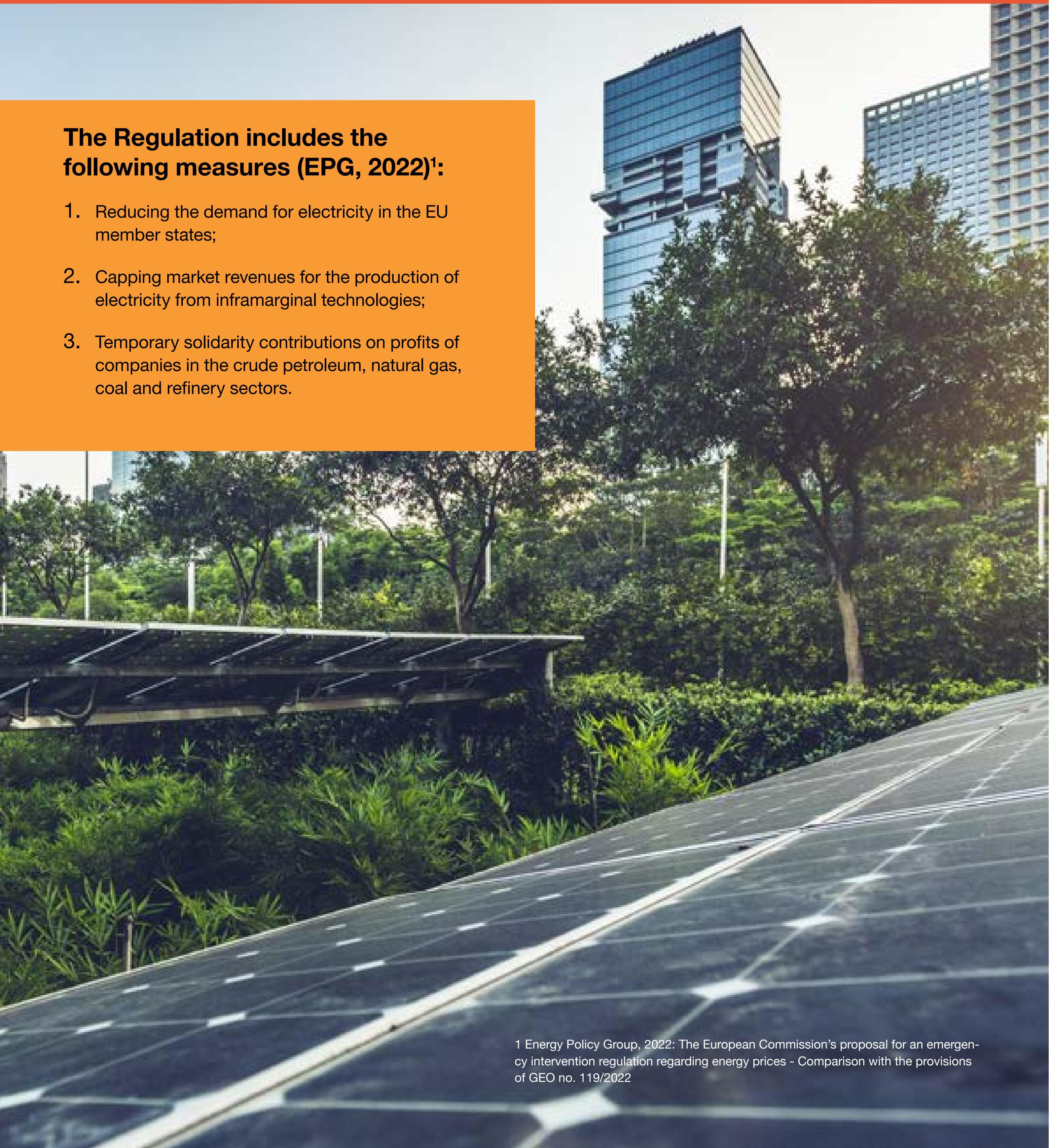
Natural gas-fired power plants are needed to meet electricity demand when it peaks during the day or when the volumes produced by other technologies, such as nuclear, hydropower or renewable energy, are insufficient to cover the demand.

Moreover, Russia's military aggression launched in February 2022 against Ukraine, a contracting party to the European Energy Community, has caused natural gas supplies across the EU to decrease significantly. The war in Ukraine has also created uncertainty about supplies of other commodities, such as coal and crude petroleum, used in electricity generation facilities, thus causing further substantial increases in, and implicitly volatility of, the electricity price.

In this context, the European Commission decided that a coordinated response was needed across the EU member states, and it published the proposal for the Emergency Intervention Regulation regarding energy prices on 14 September 2022. According to the Commission, uncoordinated national measures could affect the functioning of the internal energy market, thereby jeopardising supply security and leading to further price increases in the member states most affected by the crisis.

After a series of debates and certain amendments, Regulation (EU) 2022/1854 of the Council was published in the Official Journal of the European Union on 6 October 2022.

Regulation (EU) 2022/1854 regarding an emergency intervention to address high energy prices



The Regulation includes the following measures (EPG, 2022)[1]:

1. Reducing the demand for electricity in the EU member states;
2. Capping market revenues for the production of electricity from inframarginal technologies;
3. Temporary solidarity contributions on profits of companies in the crude petroleum, natural gas, coal and refinery sectors.

1 Energy Policy Group, 2022: The European Commission's proposal for an emergency intervention regulation regarding energy prices - Comparison with the provisions of GEO no. 119/2022

Reducing electricity demand

For the period 1 December 2022 to 31 March 2023, the Regulation provides for:

- Voluntary reduction of the total monthly gross electricity consumption by 10% from the average of the gross electricity consumption in the corresponding months of the reference period.
- Mandatory reduction of total electricity consumption by at least 5% on average per hour during the peak hours identified by member states. The reduction target is calculated as the difference between the total electricity consumption at the identified peak hours and the total consumption expected by the transmission system operator in the absence of the reduction measures.

In the version published in the Official Journal of the European Union, a provision was introduced allowing member states to choose to target a percentage of peak hours different from the peak hours that correspond in total to at least 10% of the total number of hours in the period 1 December 2022 to 31 March 2023, provided it covers at least 3% of the peak hours and that the energy saved is at least equal to the amount that would have been saved under the conditions above.

Capping market revenues for electricity production using inframarginal technologies

- Producers' market revenues derived from electricity generation are capped at EUR 180/MWh.
- The obligation applies to producers of electricity from the following sources: wind energy, solar energy (thermal and photovoltaic), geothermal energy, hydropower without reservoir, biomass fuels (solid or gaseous), except biomethane, waste, nuclear power, lignite, crude petroleum products and peat.
- Member states may maintain or introduce measures that further limit producers' market revenues, provided that these measures are proportionate and non-discriminatory, do not jeopardise investment, ensure the coverage of investment costs, do not distort the functioning of electricity wholesale markets and are compatible with European Union law.
- The cap covers all producers' market revenues, regardless of the market time frame in which the transaction takes place and whether the electricity is traded bilaterally or in a centralised marketplace, to avoid the migration of transactions to certain segments of the wholesale market.

Temporary solidarity contributions on crude petroleum, natural gas, coal and refinery sector company profits

- The solidarity contribution applies to companies which generate at least 75% of their turnover from activities in the extraction of crude petroleum, natural gas and coal, and the related refineries sectors, unless the member states have already enacted equivalent national measures.
- The temporary solidarity contribution applies to taxable profits that exceed a 20% increase in the year 2022 and/or 2023 compared to the average taxable profits of the four financial years starting on or after 1 January 2018.
- The rate applicable for the calculation of the temporary solidarity contribution is at least 33% of the taxable base calculated by reference to the surplus taxable profits determined in accordance with the Regulation's provisions. This applies only to surplus profits generated in and throughout the financial year starting on or after 1 January 2022 and/or 1 January 2023.
- If the average annual result of the period covering the four fiscal years is negative, the average taxable profit is zero when calculating the temporary solidarity contribution.
- This contribution applies in addition to the regular taxes applicable under national law.

The fiscal regime in Romania

Both in Romania and in other European states, royalties, taxes or additional contributions are levied on the oil and natural gas industry in conjunction with the regular country-specific taxation rules. Therefore, the fiscal environment applicable to Romanian companies operating in the oil and natural gas industry consists of:

- the regular taxation system, such as corporate income tax, personal income tax, VAT, excise duties, customs duties and local taxes;

and

- the sector-specific taxation system (i.e. oil and natural gas), such as:
- petroleum royalties due for the production of crude petroleum and natural gas;
- taxes on additional revenues from the sale of onshore, offshore and deep onshore natural gas;
- additional tax applicable to crude petroleum production;
- the contributions due for electricity production in power plants owned by the holders of petroleum concessions agreements;
- the contributions owed by holders of petroleum agreements for the trading of natural gas and electricity;
- the reduction of RON 0.25/litre covered by the companies in the sector for petrol and diesel fuel retail sales;
- other sector-specific contributions.

The fiscal regime specific to the oil and natural gas sector in Romania

The taxation system specific to the oil and natural gas sector currently consists of the following legislative regulations in force:

1. Petroleum royalty (Law no. 238/2004)

- The law stipulates that holders of petroleum agreements must pay a petroleum royalty to the state budget.
- The currently applicable royalty rates range between 3.5% and 13% for natural gas, and between 3.5% and 13.5% for crude petroleum, depending on the amount of gross production extracted quarterly.
- Petroleum royalties are calculated based on reference prices established by the competent authorities, with payment due on the twenty-fifth day of the following quarter.
- The reference price for natural gas used in calculating royalties is determined based on the day-ahead price of the CEGH hub in Austria, in accordance with Order no. 32/2018 issued by Romania's Agency for Mineral Resources, that price recorded significantly higher values than the average prices achieved by natural gas producers in Romania.

2. Tax on additional revenues from the sale of onshore production natural gas

(Government Ordinance no. 7/2013)

- The tax is calculated by applying a 60% rate to revenues ranging between RON 45.71/MWh, adjusted with the consumer price index CPI rate, and RON 85/MWh. For revenues exceeding RON 85/MWh, an 80% rate applies.
- Additional income royalties and upstream sector investments are tax deductible up to 30% of the taxable base, after which tax rates of 60% and 80%, respectively, apply.
- The tax on additional revenues is a deductible expense when determining taxable profit.

3. Tax on additional revenues from the sale of offshore and/or deep onshore production natural gas (Law no. 256/2018 republished with amendments to Law no. 157/2022 – "Offshore Law")

The Offshore Law was amended in May 2022 with the aim of ensuring predictability, stability and the unlocking of investments in the Black Sea[2].

- The legislative framework stipulates the obligation of entities holding petroleum agreements on offshore and deep onshore perimeters, including their subsidiaries, to calculate, declare and pay the tax on additional income.
- The additional income is determined as the difference between (1) the weighted average price of natural gas sold from own offshore and/or deep onshore internal production, from which the costs of transport, distribution, storage and other logistics costs borne by the holder of the petroleum agreement are deducted, and (2) the minimum price of the calculation interval corresponding to the pricing grid starting from RON 85/MWh, multiplied by the volume of gas sold from own offshore and/or deep onshore internal production. The rates levied on the additional income for determining the tax range between 15% and 70%, depending on the price charged. As of 1 January 2019, the price thresholds used for calculating the tax are adjusted every year, using the annual consumer price index.
- The additional income tax is a deductible expense when determining the fiscal result for corporate income tax purposes. Taxpayers' upstream segment investments are deductible up to 40% of the total additional income tax.
- The royalty regime and the fiscal regime applicable to exploration, development, exploitation and abandonment activities will not change during the application of petroleum agreements if included therein.

4. Tax applicable to crude petroleum production (Government Ordinance no. 6/2013)

This tax is calculated by applying a 0.5% rate to the revenues from the exploitation of crude petroleum, including cases where the holders of petroleum agreements process the crude petroleum in their own refineries.

2 We note that the tax on additional revenues from the sale of natural gas from offshore production applies to the targeted companies as of November 2018, thus the amendments to Law no. 157/2022 cover the tax base, the deductibility cap on investments when calculating the corporate income tax and the application of these taxes also to deep onshore production.

5. Capping natural gas prices for natural gas sales made by petroleum agreement holders, and the contribution to the Energy Transition Fund (GEO no. 27/2022 amended by GEO no. 119/2022)

- Natural gas producers are required to make available from their own production, for the suppliers of household customers and of thermal energy producers, quantities of natural gas, calculated in accordance with Annex 5 to GEO no. 27/2022, at the price of RON 150/MWh. For the electricity production in the producers' own natural gas-fired power plants, the internal transfer price (i.e. within the same legal entity) is capped at RON 100/MWh.

- The contribution to the Energy Transition Fund for electricity production (known as the windfall tax) also applies to holders of petroleum agreements that own natural gas-fired power plants and is calculated as 100% of the revenues from the sale of electricity exceeding RON 450/MWh minus the cost of CO2 certificates. From 1 April 2022 to 31 August 2022, a similar contribution of 80% applied for electricity produced in natural gas-fired power plants.

- The contribution to the Energy Transition Fund for electricity and natural gas trading, calculated as the difference between the average monthly selling price and the average monthly purchase price, is applied at a rate of only 2% to cover the rest of the operators' expenses and possibly achieve a profit margin (Annex 6.1 of GEO 27/2022 amended by GEO 119/2022 as of 1 September 2022).

6. Contribution for the reduction of petrol and diesel fuel prices (GEO no. 106/2022)

- Companies in the sector cover RON 0.25/litre of the total RON 0.5/litre discount granted by the state for retail sales of petrol and diesel fuel to end customers as of 1 July 2022 according to GEO no. 106/2022.

7. Contribution owed by licence holders (GEO no. 114/2018 amended by GEO no. 1/2020)

- As of January 2020, the level of contributions from licence holders in the electricity and natural gas sector is established annually by order of Romania's Energy Regulatory Authority (i.e. Order no. 143/2021 in force for 2022).

Conclusions

- The current context is unprecedented globally, regionally and locally, and it requires intervention measures, but these must be balanced in such a way as to ensure energy security, protect vulnerable consumers and maintain a functional energy market without discouraging investment.
- Regulation (EU) 2022/1854 regarding an emergency intervention to address high energy prices provides for a number of measures that must be complied with in the process of reviewing existing national policies.
- Specific national aspects must also be considered, including the current blockages caused by GEO 119/2022 (Concordia, 2022)[3] , such as:
    - Calculation of royalties: for the quantities transferred at the regulated price for electricity production, the royalty should be calculated by reference to the regulated price, not a price established based on a market other than the local one and significantly higher than the regulated price.
    - Contribution to the Energy Transition Fund for electricity and natural gas trading: it should be clarified which costs are covered in the category of purchase costs (e.g. costs incurred to bring the goods to the market), otherwise the current provisions constitute a prohibition of imports, as the profit margin cannot exceed the 2% threshold.
- Thus, the EU Regulation measures should implemented simultaneously with the revision of the national legislation to ensure the proper functioning of the energy market. Moreover, the application of the solidarity contribution under the EU Regulation should be examined in the context of the national fiscal regime and implicitly by virtue of its impact on investments in the sector. According to the Regulation, Romania's decision to introduce the solidarity contribution, including for the financial year(s) during which it will apply, was due to be communicated to the European Commission by 31 December 2022.
- Given that Romania has already implemented a series of national measures, as presented in our analysis, the Romanian authorities should consider the degree to which they are equivalent to the Regulation's proposed solidarity contribution provisions.

3 Concordia Employers' Confederation, 2022: Towards a solution to the energy market crisis

Important notice