The Russian CFO Summit
2004
Adam Smith Conference

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Practical issues of reforming the system of tax legislation for oil and gas

Geneva

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Shell in Russia and CIS

Working Projects:

- Sakhalin 2 (off-shore project, LNG and oil)
- Salym (on-shore, oil)
- Kashagan (shallow-water off-shore, oil)
- CPC (transportation)
- Arman oil field and MK exploration in Kazakhstan (on-shore, oil)

Experience:

- 10 years + in Russia and CIS
- Knowledge of Russian and CIS countries law, norms, standards, procedures and specifics
- Operating Joint Ventures with Russian/Kazakh/foreign partners
- Good relations with the Governments of Russia and Kazakhstan

Strategic Interests and Ambitions of Shell:

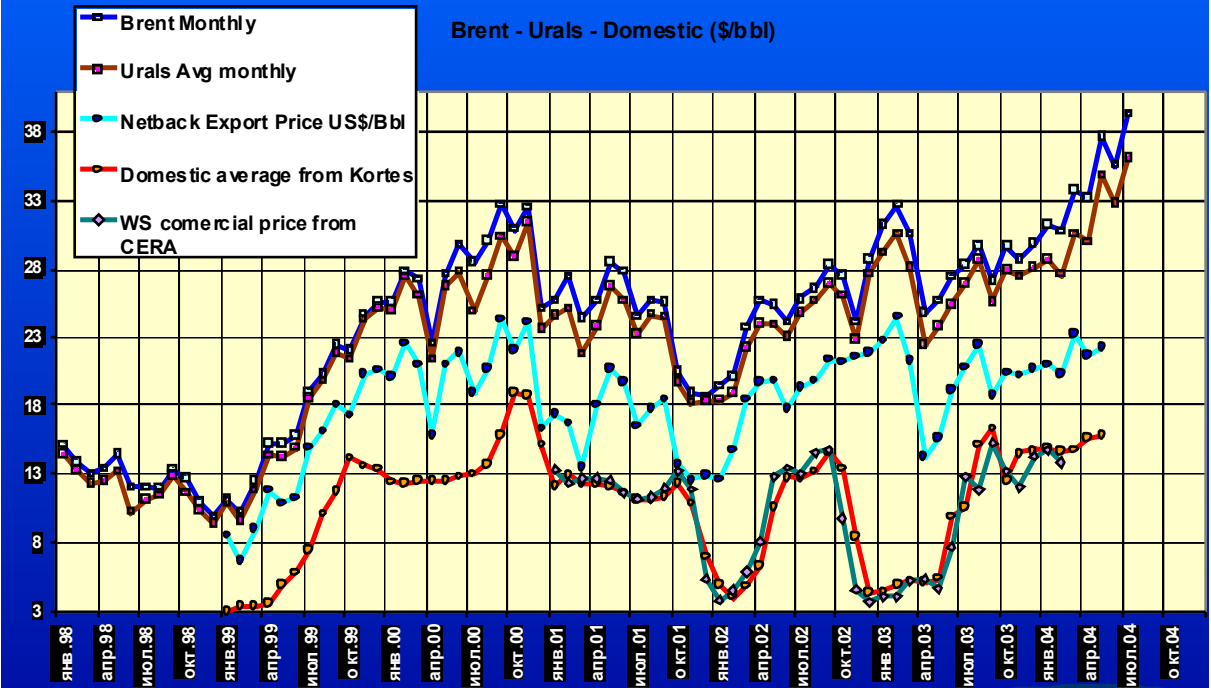
- Growth in Russia and CIS
- Participation in complex projects which require Shell specific knowledge
- Strategic alliances with strong national companies

Analysis of Impact of Mineral Taxes on company's remaining net income

Assumptions:

- Depreciation 1,5 $/bbl
- Total costs excluding depreciation, mineral taxes and profit tax = 10,5 $/bbl
- Cost level remains constant
- Domestic Sales close to the chart, but not totally in compliance with it
- No accounting for inflation
- No loss carry-forward
- Relation of Domestic Prices to Export Prices is artificial

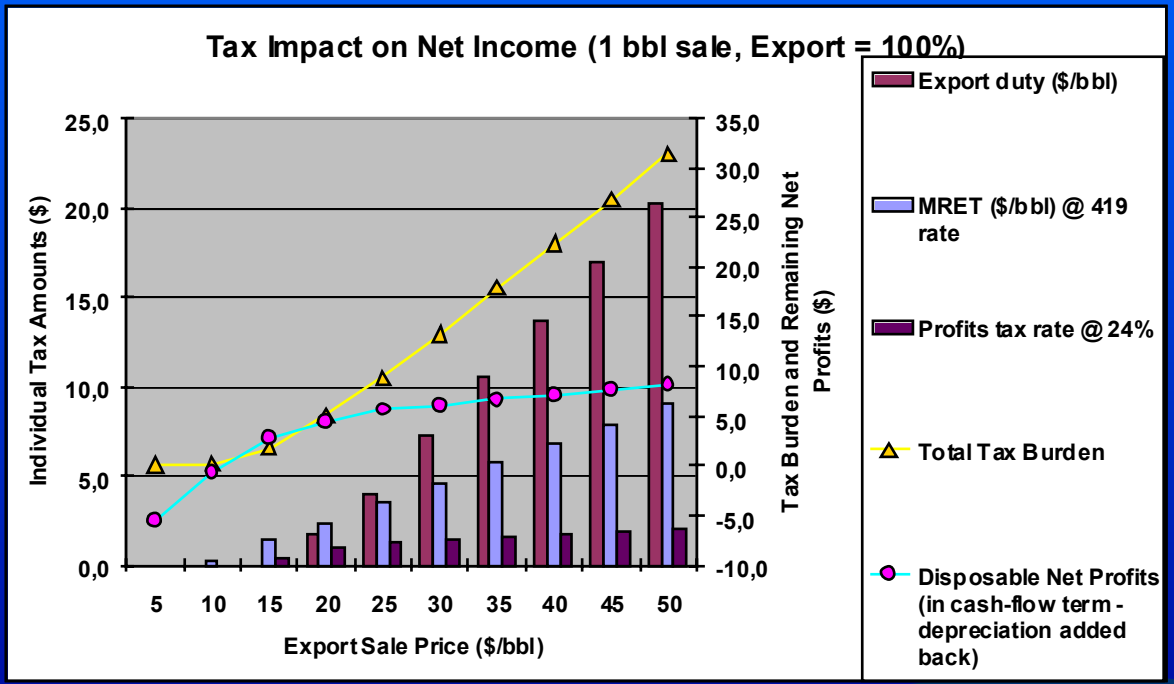
Analysis of Impact of Mineral Taxes on company's remaining net income:
Crude Oil Prices



Calculation Table (Export = 100%)

Inflation Rate	0% 29,5			0 Add to cost						
World market = export price per Unit ($/bbl)	5	10	15	20	25	30	35	40	45	50
Quantity (bbls)	1,0	1,0	1,0	1,0	1,0	1,0	1,0	1,0	1,0	1,0
Export Sale Proceeds	5,0	10,0	15,0	20,0	25,0	30,0	35,0	40,0	45,0	50,0
Domestic Price per Unit ($/bbl)	3,0	3,3	4,8	11,8	16,4	14,3	18,1	19,0	26,9	29,7
Domestic Sale Proceeds	3,0	3,3	4,8	11,8	16,4	14,3	18,1	19,0	26,9	29,7
Cost per Unit ($/bbl)	10,5	10,5	10,5	10,5	10,5	10,5	10,5	10,5	10,5	10,5
Depreciation per unit ($/bbl)	1,5	1,5	1,5	1,5	1,5	1,5	1,5	1,5	1,5	1,5
Total Costs	12,0	12,0	12,0	12,0	12,0	12,0	12,0	12,0	12,0	12,0
Profit after cost Deduction	-7,0	-2,0	3,0	8,0	13,0	18,0	23,0	28,0	33,0	38,0
Export duty ($/bbl)	0,0	0,0	0,0	1,8	4,0	7,3	10,5	13,8	17,0	20,3
MRET ($/bbl) @ 419 rate	0,0	0,2	1,3	2,4	3,5	4,6	5,7	6,8	7,9	9,0
Export Duty+MRET	0,0	0,2	1,3	4,2	7,5	11,9	16,2	20,6	24,9	29,3
Profit before Tax	-7,0	-2,2	1,7	3,8	5,5	6,1	6,8	7,4	8,1	8,7
Profits tax rate @ 24%	0,0	0,0	0,4	0,9	1,3	1,5	1,6	1,8	1,9	2,1
Profit After Tax	-7,0	-2,2	1,3	2,9	4,2	4,7	5,2	5,6	6,1	6,6
Total Tax Burden	0,0	0,2	1,7	5,1	8,8	13,3	17,8	22,4	26,9	31,4
Disposable Net Profits (in cash-flow term - depreciation added back)	-5,5	-0,7	2,8	4,4	5,7	6,2	6,7	7,1	7,6	8,1
Effective tax rate (%)	0,0	2,2	11,5	25,4	35,3	44,5	51,0	55,9	59,7	62,7
Marginal effective tax rate (%)		4,4	30,1	67,3	74,9	90,1	90,1	90,1	90,1	90,1

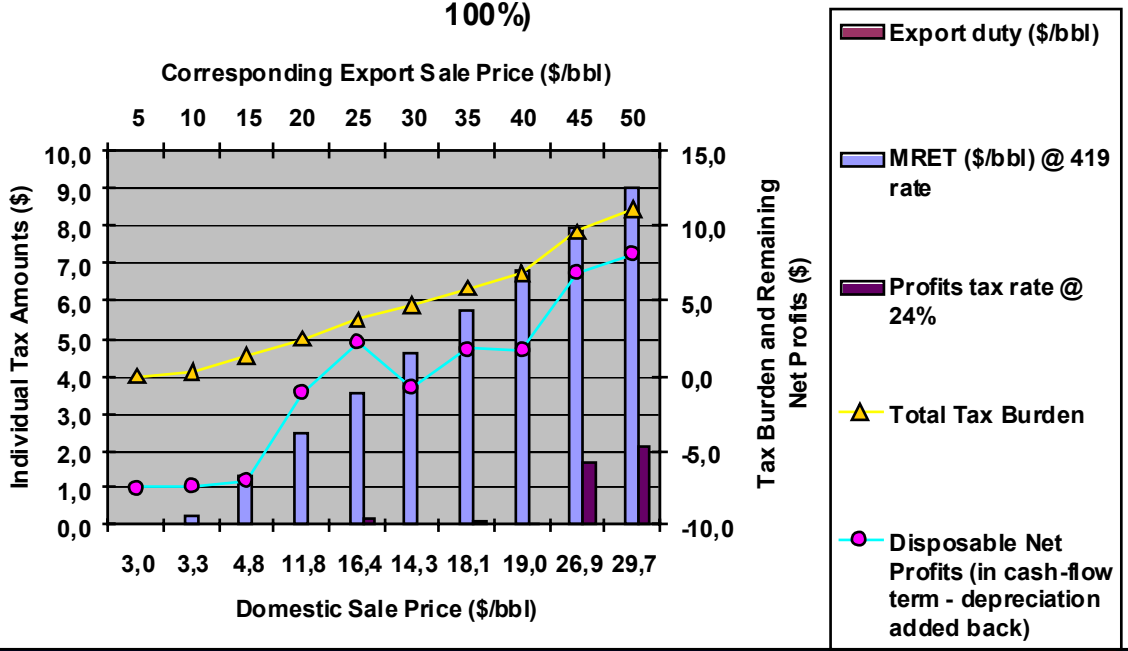
Analysis of Impact of Mineral Taxes on company's remaining net income:
100% Export



Calculation Table (Domestic Sales = 100%)

Inflation Rate	0% 29,5			0 Add to cost						
World market = export price per Unit ($/bbl)	5	10	15	20	25	30	35	40	45	50
Quantity (bbls)	1,0	1,0	1,0	1,0	1,0	1,0	1,0	1,0	1,0	1,0
Export Sale Proceeds	5,0	10,0	15,0	20,0	25,0	30,0	35,0	40,0	45,0	50,0
Domestic Price per Unit ($/bbl)	3,0	3,3	4,8	11,8	16,4	14,3	18,1	19,0	26,9	29,7
Domestic Sale Proceeds	3,0	3,3	4,8	11,8	16,4	14,3	18,1	19,0	26,9	29,7
Cost per Unit ($/bbl)	10,5	10,5	10,5	10,5	10,5	10,5	10,5	10,5	10,5	10,5
Depreciation per unit ($/bbl)	1,5	1,5	1,5	1,5	1,5	1,5	1,5	1,5	1,5	1,5
Total Costs	12,0	12,0	12,0	12,0	12,0	12,0	12,0	12,0	12,0	12,0
Profit after cost Deduction	-9,0	-8,7	-7,2	-0,2	4,4	2,3	6,1	7,0	14,9	17,7
Export duty ($/bbl)	**0,0**	**0,0**	**0,0**	**0,0**	**0,0**	**0,0**	**0,0**	**0,0**	**0,0**	**0,0**
MRET ($/bbl) @ 419 rate	**0,0**	**0,2**	**1,3**	**2,4**	**3,5**	**4,6**	**5,7**	**6,8**	**7,9**	**9,0**
Export Duty+MRET	0,0	0,2	1,3	2,4	3,5	4,6	5,7	6,8	7,9	9,0
Profit before Tax	-9,0	-8,9	-8,5	-2,7	0,9	-2,3	0,4	0,2	7,0	8,7
Profits tax rate @ 24%	**0,0**	**0,0**	**0,0**	**0,0**	**0,2**	**0,0**	**0,1**	**0,1**	**1,7**	**2,1**
Profit After Tax	-9,0	-8,9	-8,5	-2,7	0,6	-2,3	0,3	0,2	5,3	6,6
Total Tax Burden	0,0	0,2	1,3	2,4	3,7	4,6	5,8	6,9	9,6	11,1
Disposable Net Profits (in cash-flow term - depreciation added back)	**-7,5**	**-7,4**	**-7,0**	**-1,2**	**2,1**	**-0,8**	**1,8**	**1,7**	**6,8**	**8,1**
Effective tax rate (%)	0,0	6,6	27,3	20,6	22,7	32,3	32,1	36,1	35,6	37,4
Marginal effective Tax Rate (%)		**68,7**	**72,8**	**15,9**	**28,3**	**-42,8**	**31,2**	**112,0**	**34,6**	**54,0**

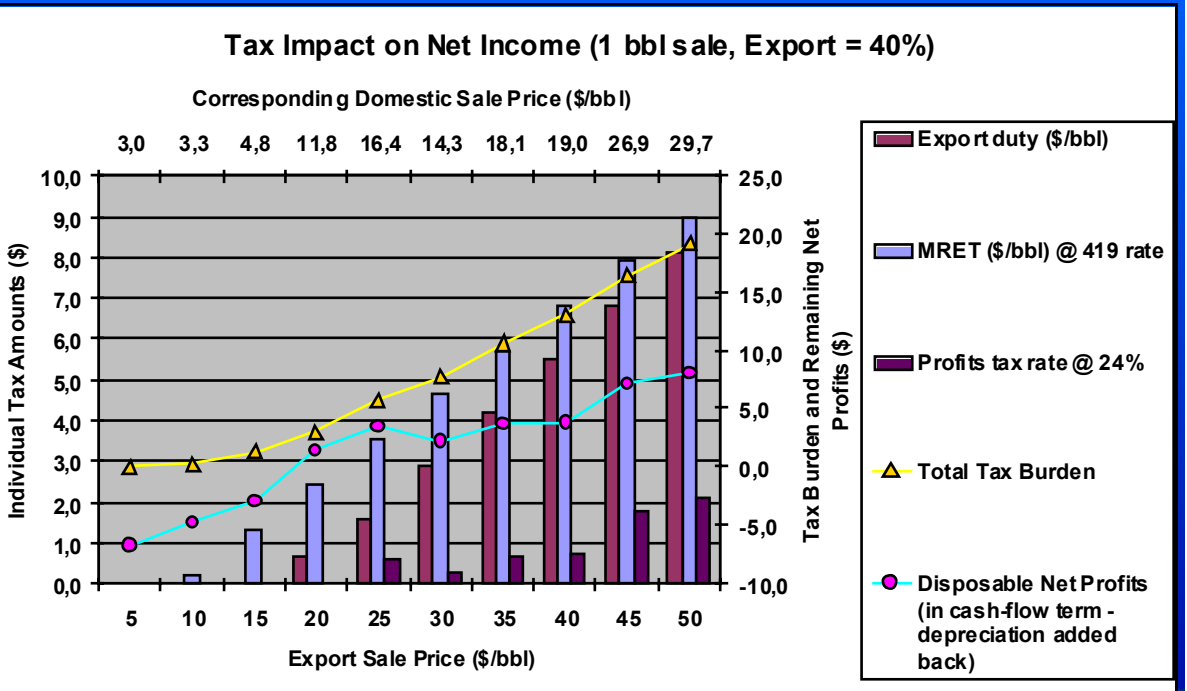
Analysis of Impact of Mineral Taxes on company's remaining net income:
100% Domestic Sales



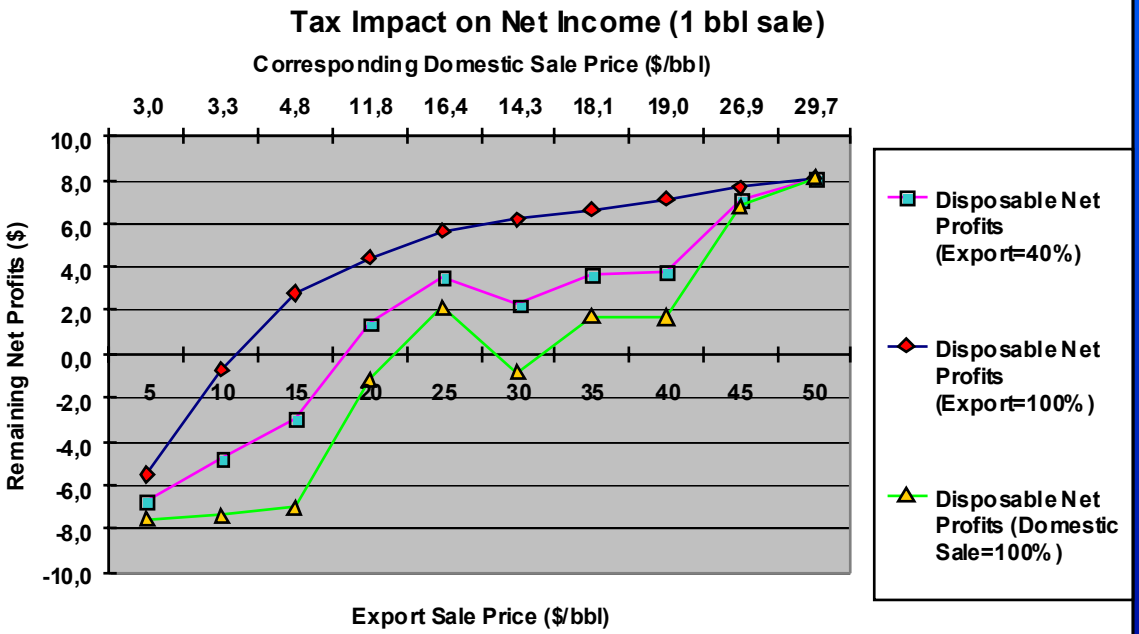
Calculation Table (40% = Export, rest = Domestic)

Inflation	0%			0 Add to cost						
Export Share =	40%									
Rate	29,5									
World market = export price per Unit ($/bbl)	5	10	15	20	25	30	35	40	45	50
Quantity (bbls)	1,0	1,0	1,0	1,0	1,0	1,0	1,0	1,0	1,0	1,0
Export Sale Proceeds	2,0	4,0	6,0	8,0	10,0	12,0	14,0	16,0	18,0	20,0
Domestic Price per Unit ($/bbl)	3,0	3,3	4,8	11,8	16,4	14,3	18,1	19,0	26,9	29,7
Domestic Sale Proceeds	1,8	2,0	2,9	7,1	9,8	8,6	10,9	11,4	16,1	17,8
Cost per Unit ($/bbl)	10,5	10,5	10,5	10,5	10,5	10,5	10,5	10,5	10,5	10,5
Depreciation per unit ($/bbl)	1,5	1,5	1,5	1,5	1,5	1,5	1,5	1,5	1,5	1,5
Total Costs	12,0	12,0	12,0	12,0	12,0	12,0	12,0	12,0	12,0	12,0
Profit after cost Deduction	-8,2	-6,0	-3,1	3,1	7,8	8,6	12,9	15,4	22,1	25,8
Export duty ($/bbl)	**0,0**	**0,0**	**0,0**	**0,7**	**1,6**	**2,9**	**4,2**	**5,5**	**6,8**	**8,1**
MRET ($/bbl) @ 419 rate	**0,0**	**0,2**	**1,3**	**2,4**	**3,5**	**4,6**	**5,7**	**6,8**	**7,9**	**9,0**
Export Duty+MRET	0,0	0,2	1,3	3,1	5,1	7,5	9,9	12,3	14,7	17,1
Profit before Tax	-8,2	-6,2	-4,4	-0,1	2,7	1,0	2,9	3,1	7,4	8,7
Profits tax rate @ 24%	**0,0**	**0,0**	**0,0**	**0,0**	**0,6**	**0,3**	**0,7**	**0,7**	**1,8**	**2,1**
Profit After Tax	-8,2	-6,2	-4,4	-0,1	2,1	0,8	2,2	2,4	5,6	6,6
Total Tax Burden	0,0	0,2	1,3	3,1	5,8	7,8	10,6	13,1	16,5	19,2
Disposable Net Profits (in cash-flow term - depreciation added back)	**-6,7**	**-4,7**	**-2,9**	**1,4**	**3,6**	**2,3**	**3,7**	**3,9**	**7,1**	**8,1**
Effective tax rate (%)	0,0	3,7	14,8	20,7	29,1	37,8	42,7	47,6	48,3	50,8
Marginal Effective Tax Rate (%)		**10,0**	**37,8**	**29,2**	**55,6**	**268,5**	**66,5**	**95,0**	**51,2**	**73,6**

Analysis of Impact of Mineral Taxes on company's remaining net income:
40% Export, 60% Domestic sales



Analysis of Impact of Mineral Taxes on company's remaining net income:
Comparison of Remaining Net Profits



Analysis of Impact of Mineral Taxes on company's remaining net income:
Upstream Marginal Tax Rates

RUSSIAN FEDERATION MARGINAL TAX RATES ON UPSTREAM
Effective January 1, 2005

	Urals CIF price ($/bbl)				
	< $8	$8 < $15	$15 < $20	$20 < $25	> $25
Crude oil exports					
Mineral Extraction Tax (MET)	0,0%	22,0%	22,0%	22,0%	22,0%
Export tariff	0,0%	0,0%	35,0%	45,0%	65,0%
Profit Tax	24,0%	18,7%	10,3%	7,9%	3,1%
Total effective marginal tax rate	**24,0%**	**40,7%**	**67,3%**	**74,9%**	**90,1%**
Domestic sales of crude					
Mineral Extraction Tax (MET)	0,0%	22,0%	22,0%	22,0%	22,0%
Export tariff					
Profit Tax	24,0%	18,7%	18,7%	18,7%	18,7%
Total effective marginal tax rate	**24,0%**	**40,7%**	**40,7%**	**40,7%**	**40,7%**

Analysis of Impact of Mineral Taxes on company's remaining net income: Conclusion

Conclusion:

- 100% export sale gives more volume of net income up to 50$/bbl price (depending on corresponding domestic price)
- Increase in costs moves lines down, but do not change angle
- At prices higher than 50$/bbl export becomes less attractive compared to domestic sales
- At prices higher than 50$/bbl - because of excess domestic supply the spread between domestic and export sales will start to increase
- 100% Export has lower capacity to sustain cost increase
- At export prices higher than 25$/bbl practically all additional income goes to Government Take
- Low level of savings for future investments into exploration, reserve replacement and potential acquisitions
- If loss c/f are modeled – position of a company will be slightly better

Analysis of Impact of Mineral Taxes on company's remaining net income:
Abandonment Fund Suggested Provisions

Wording to article 261 as per suggested amendments to Chapter 25 of the RF Tax Code	Comments and Issues to be addressed
The expenses of organizations who are subsoil users on abandonment .... may be accounted... 1) at the expense of the reserve for abandonment... to be formed for each area or facility.	Ideally the "reserve fund" should be allowed as a deduction on an accrual basis rather than on cash basis. The abandonment regime should be elective to the taxpayer on a by field basis (eg. reserve fund – for one field and expensing within 5 years for another)
The taxpayer who decided to form the reserve shall reflect the procedure for its formation in his accounting policy for taxation purposes.	Difficult to do assuming the absence of the procedures for fund formation and investments of money issued by the RF Government
The size of the reserve for each area or facility must be confirmed by the relevant feasibility study or by project cost estimate documentation for development of subsoil resources which envisage the size of the said operations.	Not clear how to determine abandonment costs based on the feasibility study or project cost estmate. Should inflation be accounted for? Discounting?
Contributions to the reserve shall be made after 3 years from the commercial production starting date and shall end 3 years before the projected end time of the area's/facility's operation and shall be taken, within the structure of expenses, monthly and in equal portions, until the reserve size is achieved that is defined in the feasibility study or the project cost estimate documentation for each area or facility.	The procedures for deductions of contributions in to reserve are not clear. Ether in equal portions till the reserve size is achieved as per feasibility study (i.e. theoretically 50% in first month and 50% in the second) or in equal portions within the license time less 6 years? The taxpayer should be given a broader range of time in which to start making the accrual to the reserve (eg. from no earlier than 3 years after the commencement of commercial production but no later than five years before the projected time for abandonment). It is easier to estimate the abandonment cost closer to the end of the field life. What should one do wth existing licenses where there is no mentioning or not detailed mentioning of reserve fund?

Analysis of Impact of Mineral Taxes on company's remaining net income:
Abandonment Fund Suggested Provisions (continued)

Wording to article 261 as per suggested amendments to Chapter 25 of the RF Tax Code	Comments and Issues to be addressed
The cash resources accumulated in the reserve must be placed as long-term financial investments into bonds circulated on the organized securities market, in accordance with the rules of reserve formation and use and placement of its resources to be approved by the Russian Federation Government.	This is non-tax issue! Whether the interest on bonds is considered to become the part of the abandonment reserve or is recognized as other non-sale income? What RF Government rules are referred to? Could the reserve amount be adjusted for inflation and when? Why in obligations and to which bonds in particular (state, corporate, etc.)?
In case actual expenses on operations in abandonment and/or suspension of mining sites and other facilities related to subsoil use exceed the reserve formed, the sum of excess shall be acknowledged the taxpayer's expenses uniformly over 5 years after the operations are completed.	The error in estimating the reserve fund amount will lead to the fact that the actual excess expenses would be allowed to be amortized only after completion of abandonment works over 5 years. This will affect small producers and one-license companies as taxpayers may not have income to offset the amortized expense. Any abandonment cost that exceed the reserve should be deductible in the year paid. Even better – introduce losses carry back provisions.
In case the taxpayer has used the cash resources of the reserve for purposes other than the dedicated ones within the field operation period or within the time period of operations in abandonment and/or suspension of mining sites or other facilities related to subsoil use, the total amount of the reserve shall be increased based on the double refinancing rate of the Russian Federation Central Bank effective as of the date when the reserve amount was taken into account within other expenses over the time period from this date to the ending date of the reporting (tax) period in which the non-dedicated use occurred and, shall be included, for the purposes of determining the tax base for the said reporting (tax) period, into non-sale income. A similar procedure shall apply in respect of the reserve balance in case actual expenses on abandonment and/or suspension of mining sites or other facilities related to subsoil use prove to be less than the actual reserve formed	It is unclear what is the starting day for counting the interest on the misuse - is it the day of the very first allocation to the fund or the day of the first misuse? Is interest just on the misused amount or the whole amount of reserve? In the case a taxpayer overestimates the amount necessary, the taxpayer should not only pay tax on it? But also pay interest and in the worst case scenario – on the whole reserve amount. Should investments into different securities (other than bonds) be considered as misuse? What will be if securities lose value? Should a taxpayer create a reserve for that purposes as well? When does the interest at double the CBR refinancing rate begin?

Analysis of Impact of Mineral Taxes on company's remaining net income:
Abandonment Fund Suggested Provisions (continued)

Wording to article 261 as per suggested amendments to Chapter 25 of the RF Tax Code	Comments and Issues to be addressed
2) uniformly within 5 years starting the month that follows the month when the said operations were completed.":	If a company was created specially for one particular license, the norm does not work as there would not be any profits in future. Ideal solution – to allow loss carry back or at least allow consolidation (not ring fenced field by field accounting)

Practical issues of reforming the system of tax legislation for oil and gas

Thank you for your attention!

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