

# Europe's High Energy Costs

## The Case for a Resource Rent Tax



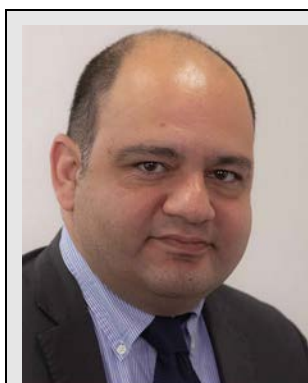
# Europe's High Energy Costs: The Case for a Resource Rent Tax

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In this article, Michail considers the effectiveness of levying windfall taxes like the resource rent tax on petroleum companies to better stabilize the economic turmoil of

high energy prices while not discouraging oil company risk capital investment.

Petroleum fiscal systems comprise a set of rules, regulations, and laws that govern the relationship between petroleum companies and host states. They are not created in a vacuum; rather they reflect the conditions and circumstances of the host state.

A resource rent tax (RRT) is commonly applied to the upstream petroleum industry — exploration and production. But it may also appear in the downstream energy industry — distribution of energy to the consumer — when external conditions disturb the market's proper functioning. Typically, RRTs apply in conjunction with other taxes, such as corporate income tax.

RRT is a progressive fiscal tool that tries to increase the government's take while avoiding economic activity distortion. To do so, it targets pure economic rent, and its design and application rest on the principles of equity, neutrality, and efficiency. These principles are typically found at the center of a national tax system and its operative provisions.

This article elaborates on the RRT and the equity, neutrality, and efficiency principles,

including exploration of the “economic rent” concept lying at the heart of the RRT. I then lay out the dire energy situation in the EU. Finally, I suggest RRT use after considering the high energy price environment. Nevertheless, I also underline the necessity for this mechanism to be properly designed and implemented, and the need to encourage petroleum companies to reinvest their profits.

### Equity, Neutrality, and Efficiency Principles

Soaring energy prices lead to dead-weight losses.<sup>1</sup> These may be construed as the “losses” sustained by households because of the escalating cost of living. The household's resources are diverted from the highest value use to the petroleum or energy companies. National governments are forced to raise more funds from capital markets to create household safety nets. This affects the government's balance of payments and credit standing and creates a budget deficit.

Against this backdrop, national governments deploy fiscal tools to increase tax revenue. The goal is to capture part of petroleum companies' windfall profits and channel them back to the households via subsidies. RRT is a fiscal tool that raises government income from pure economic rent. The principles of neutrality, efficiency, and equity play an important role.

Neutrality encompasses tax measures that “reduce disposable income without affecting decisions on consumption, trade, or production.”<sup>2</sup> The efficiency principle is combined with the neutrality principle to create optimal taxation.<sup>3</sup>

<sup>1</sup> Carol A. Dahl, “Chapter 4: Energy Price Controls, Taxes, Subsidies, and Social Welfare,” in *International Energy Markets: Understanding Pricing, Policies, and Profit* 71 (2nd ed., 2015).

<sup>2</sup> Carole Nakhle, “Petroleum Taxation: A Critical Evaluation With Special Application to the U.K. Continental Shelf,” at 22 (July 2004).

<sup>3</sup> *Id.*

The two principles signify that a state should collect its fair share of pure economic rent without distorting or restraining economic activity and foreign investment. RRT targets the windfall profits after subtracting relevant costs and a reasonable rate of return (economic rent). RRT scales up government take, but only after allowing the investor to recoup costs and receive a fair return on equity.

The equity principle has two dimensions:

- horizontal equity, requiring that firms with similar cost bases and operational features are taxed in the same way;<sup>4</sup> and
- vertical equity, tied to the ability to pay, suggesting that “those having greater ability to pay should be taxed more heavily.”<sup>5</sup>

Petroleum companies have seen their profits surge in the face of skyrocketing energy prices. On the other end of the spectrum, high prices exacerbate cost-of-living increases for households. In this environment, levying RRT on petroleum companies is an example of raising the tax burden on those with a greater ability to pay.

### Resource Rent Tax

The RRT rests on three vital parameters: the rate, the threshold rate or discounting factor, and the cost base. The RRT will apply after the investor recoups the costs and receives its threshold rate of return. The RRT will rely on a discounted cash flow arithmetic model in which costs and revenues will be accounted for and will apply after the threshold rate is achieved. The threshold rate will be used to discount the cash flows over a time horizon.

The threshold rate represents the return that the petroleum company should attain before the RRT is triggered. It consists of two key components:

- the base rate; and
- the risk premium that reflects the specific risks for undertaking the project and operating in the specific industry and country.

The weighted average cost of capital (WACC) may be employed as a threshold rate. It blends the cost of debt and the cost of equity, reflecting their respective weights across total capital. However, a risk-adjusted WACC may be used instead if the project’s risk profile deviates substantially from risk profiles in the petroleum or energy company’s other existing operations.

The cost base is the actual costs sustained by the petroleum companies. It commonly includes capital expenditure that should be recouped before the RRT applies or spread over a reasonable period. This limits the capital cost deduction allowed annually but permits the remaining costs to be carried forward.

Operating costs include direct and indirect (general and administrative expenditure) and are deductible when incurred. Financial costs may be excluded or restricted. Accounting depreciation will be excluded. Special care should be taken to avoid inflating costs either because of intragroup charges or allocation of unrelated and disproportional indirect costs.

Despite its principled attractiveness, RRT “conceals” the following weaknesses that may impede its proper functioning:

- The implementation and monitoring of the RRT can be cumbersome because it involves complicated calculations and factors that must be considered. It will necessitate significant cost and time for its application (from the petroleum companies’ perspective) and intensive administrative effort to handle the amount and type of information required to demonstrate accuracy and validity to the tax administration.
- The setting of the threshold rate is not easy. It involves subjectivity and predictions, especially if a risk adjusted WACC is used.
- If not well-implemented, the RRT may remove incentives for petroleum companies, hamper additional investment in the up-, mid-, or downstream petroleum and energy sectors, or force marginal projects to be abandoned.

### Economic Rent

RRT must exclusively target pure economic rent. It should be triggered only after petroleum

<sup>4</sup> *Id.* at 23.

<sup>5</sup> *Id.*

and economic companies have recouped their marginal cost (from an economic perspective, the marginal cost includes the investor's costs and return on equity).

Economic rent is the "true value of the natural resource, the difference between the revenues generated from resource extraction and the costs of extraction,"<sup>6</sup> in the petroleum industry. It is the excess profits after subtracting the cost and a reasonable rate of return.

There are three types of economic rent:

- hoteling rent<sup>7</sup> rests on the scarcity of the nonrenewable resource and represents the benefit forfeited by extracting and producing the nonrenewable resource now;
- Ricardian rent<sup>8</sup> is the quality of the land suggesting that a better-quality soil may lead to increased productivity and higher rent; and
- quasi-equity rent<sup>9</sup> is receiving equity return in the short run but not enough to recoup the sunk capital cost in the long run.

Raising the government's take through the RRT by capturing part of the hoteling or Ricardian rent should not impede the functioning of the petroleum industry. In principle, it will apply to excess profits after the petroleum companies recoup cost and receive the return on equity.

However, RRT should not capture quasi-equity rent. Doing so will negatively affect the sector by discouraging petroleum companies from investing risk capital into existing or new projects.

### The Perfect Storm

The twin pillars of energy security and access to energy should be at the core of an energy strategy designed to ensure that households have uninterrupted access to energy at affordable prices. Neglecting these principles opens a

Pandora's box of high prices, political unrest, and economic downturn.

The EU energy strategy neglected these two principles with the phasing down of domestic natural gas production. It has resulted in an increase in dependency on clean energy imports to meet emissions goals.

The war in Ukraine and the weaponization of Russian gas has worsened the situation. Brussels and EU member states are bracing for a perfect storm of severe recession and economic turbulence. Households face an increasing cost of living while salaries remain stagnant. National governments are looking for help through fiscal means for fear that the situation could degenerate into social and political unrest.

At the same time, petroleum company profits have surged. They are earning considerable hoteling rent because of the scarcity of natural gas and high energy prices. Petroleum company profits have continued to shatter records, leading to massive dividend payouts and buybacks.

This is where the RRT comes in. National governments are considering an RRT (some have already introduced the tax) to raise revenues to provide fiscal aid to households and industries. However, national governments should also consider that petroleum companies have endured a difficult period because of COVID-19, with low prices and massive losses. Capturing windfall profits now could discourage petroleum companies from scaling up investment in exploration and production, or midstream infrastructure. This will only perpetuate high energy prices.

### RRT Formulation

The situation calls for an RRT. However, it should be well structured, targeting only pure economic rent. It should avoid discouraging petroleum companies and instead encourage them to pump additional risk capital into exploration and production projects or construction of midstream infrastructure.

Clear guidelines should be released explaining the tax's operation and key components. The guidelines should define allowable costs and the basis for determination of the threshold rate. Tax authorities should provide an opportunity for petroleum companies to

<sup>6</sup> Nakhle, "Chapter 2: The Taxation of Oil: Theoretical Background," in *Petroleum Taxation: Sharing the Oil Wealth: A Study of Petroleum Taxation Yesterday, Today and Tomorrow* 28 (2008).

<sup>7</sup> *Id.* at 31.

<sup>8</sup> *Id.*

<sup>9</sup> Dahl, "Chapter 8: Market Structure, Transaction Cost Economics, and U.S. Natural Gas Markets," *supra* note 1, at 185.

discuss the RRT in advance. Tax administrations should form special teams for verifying the accuracy of RRT calculations.

Special allowances or tax breaks should be available to petroleum companies to set off risk capital costs or offer other assistance to reduce the overall RRT burden. For example, an RRT in the EU should use allowances to encourage petroleum companies to divert risk capital to exploration and production within the EU in brownfield or greenfield projects. The North Sea may be an option, as is Cyprus, where explorations are underway that have already made significant gas discoveries. Scaling up EU indigenous gas production could alleviate the difficulties and bolster energy security.

An RRT should take account of petroleum company prior-year losses during the peak of the pandemic. The companies should be allowed to use the losses to offset the RRT in specific conditions.

## Conclusion

This article discusses the conceptual framework behind the application of an RRT. The tax targets pure economic rent but should not target quasi-equity rent. High energy prices have stretched the budgetary limits of national governments and generated economic pressure on households, in some cases threatening political and social unrest. At the same time, surging energy prices have increased profits of petroleum and energy companies across the board.

In this environment, national governments are considering applying an RRT that targets pure economic rent. But the tax must also award allowances to stimulate exploration and production or construction of midstream infrastructure. Additional investment in the upstream, midstream, and downstream petroleum industry will allow Europe and the world to weather the energy crisis. ■