

Ukraine's Tax Hike Will Strangle the Domestic Oil and Gas Sector

Written by Ariel Cohen
Friday, 13 March 2015 00:00

Ukraine is facing existential challenges, and energy security is one of them. The country is dependent on Russia supplying most of its natural gas as well as uranium fuel for its nuclear reactors. Under these very difficult circumstances, a government with a holistic view of its strategic security and energy goals would logically develop a policy aimed at encouraging increased domestic oil and gas production. Unfortunately, Kyiv is doing the opposite.

Despite the massive Western support it is receiving, Kyiv is promulgating ill-conceived anti-market policies and hare-brained schemes that are set to make matters worse – much worse.

My recent trip to Kyiv to speak at the Adam Smith 6th annual energy conference on energy diversification conference left me disappointed and worried. In recent years, the Western majors, including Shell, BP, Chevron and VITOL, have made commitments to exploration and production in Ukraine. Many have left due to the war with Russia. The more risk-tolerant and the scrappiest among the smaller companies have remained, including JKK, Arawak, and Cub Energy.

Due to the need to fill the state coffers to pay back the forthcoming International Monetary Fund's \$17 billion loan, the Government of Ukraine is about to commit hydrocarbon hara-kiri. It has imposed exorbitant taxes on local oil and gas producers and is forcing them to sell their output to the government-owned monopoly. This is exactly the opposite of what one would expect from a reformist government densely populated with pro-market technocrats from the US, Lithuania and Georgia.

Kyiv's new tax rates are mindboggling. First, there is a royalty, which taxes output sales, not just profits. Second, the rates are 70% for state-owned production companies; 55% on wells under 5,000 meters depth, and 35% on wells over 5,000 meters.

This is self-defeating: the local production of oil and gas will be increasingly depressed, billions of dollars a year will continue flowing into Russian coffers, and Ukraine will have to keep borrowing from the IMF to pay Mr. Putin.

This punitive and confiscatory taxation has been imposed when the other major source of Ukrainian power generation – anthracite coal – is no longer accessible, as most of the mines are in the country's east, in the ageing Donetsk basin (Donbass). Not only is the Donbass area a war zone, Donbass coal is so expensive, it is uneconomical.

To make matters worse, half of Ukraine's energy is produced at its ageing Soviet-built power stations. The uranium fuel for these is supplied by ROSATOM, the Russian energy monopoly. This further deepens Ukraine's strategic dependence on Russia and opens it to energy blackmail.

Prof. Alan Riley of City University of London has compared the new tax measures to suffocate gas production to Soviet dictator Joseph Stalin's early efforts to strangle the partially-market based New Economic Policy (NEP).

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Before arresting people en masse and forcibly collectivizing agriculture, Stalin imposed very high taxes on privately owned business in the USSR. As the result, the private sector withered and collapsed. Then the NKVD secret police just finished off the peasants and the entrepreneurs, sending them off to GULAG camps. As Stalin used to say: “no person – no problem”.

One does not expect Ukrainian oil and gas executives to be arrested in the dead of night and summarily shot, or sent to Siberia to cut trees in the taiga. However, these punitive taxes may well force them to shutter their businesses and leave the country.

“We would be happy to explore and produce in Ukraine,” says Alastair McBain, CEO of Arawak, the VITOL subsidiary. However, in yet another example of how the Ukrainian government is failing to create the conditions for companies to do so: Russia allows 104,000 square kilometers of territory per year to be explored with 3D seismic, whereas in Ukraine only 300 km per year can be explored.

“We don’t know one thing: what to expect from the government”, says Philip Vorobyev, Director of Business Development with JKC. “The Government views upstream as a cash cow.

This lack of strategic overview and leadership is explained by some business executives as a move by Kyiv to punish hostile oligarchs who are partners in some of the E&P companies. Which raises the question, so who benefits? The punitive taxation is likely to force them to sell out to oligarchs who are friendly to the Cabinet, local business analysts say.

Over the years, top both Ukrainian oligarchs and politicians have benefited from subsidized gas prices which kept their gas-guzzling, energy inefficient industries running. The politicians continued to be elected by a population addicted to cheap natural gas, while both the oligarchs and the politicians made billions of dollars importing and distributing gas from GAZPROM. Russian oligarchs close to Putin were their business partners, Kyiv insiders say. These businessmen would be happy to continue their symbiosis with Moscow.

But the game is over. Ukraine cannot continue its dependence on Russian gas for geopolitical reasons. It can only thrive by increasing local production. Sending Western investors packing would be suicidal.

The Poroshenko-Yatsenyuk administration needs to revise their punitive tax rates. Royalty fees need to be replaced by a reasonable corporate income tax, and Western advisors should be engaged to help restructure the industry to favor local production.

The Ukrghazdobycha, Transgas and Naftogaz Ukrainy state-owned companies should be privatized, and not into the hands of Russia and its allies. The sand in the hour glass is running out – Ukraine must reform its oil and gas sector before investors abandon it – and before its dependence on Russian energy grows even greater.

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Security.

This article was previously published in [Natural Gas Europe](#)