Frontiers

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Should oil-producing countries rethink fiscal regimes?

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The extended period of lower crude prices has created challenges for both oil and gas companies and nations that rely heavily on oil revenues.

In reaction, oil and gas companies have made a number of changes to improve competitiveness and maintain viability in a low oil price environment – portfolio adjustments, headcount and cost reductions, and more.

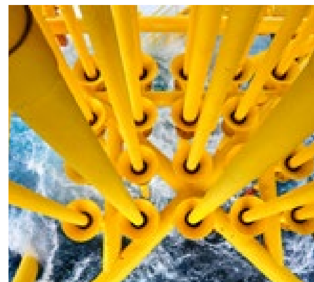
Nations heavily dependent on oil revenues have responded less quickly, but this may be changing.

As the price of crude slipped below US$50 and stayed relatively flat, capital investment into the sector slowed considerably. Investors familiar with oil and gas increasingly exhibit a preference for North American shale in the public equity, private equity and debt investment arenas. US companies, too, have increased their focus on domestic shale, which benefits from lower costs, more favorable regulations, less risk and a stable fiscal regime when compared with foreign investments.

The end result of these changes is that, for oil-producing countries, revenue has dropped significantly. Many nations with hydrocarbon resources are highly geared toward upstream oil and are under pressure as prices have gone down by half and the ever-present decline curve continues to push volumes lower.

These price and volume issues are compounded by the fact that national oil companies (NOCs) are often constrained by employment requirements that limit the cost-reduction potential available to private firms, as well as a lack of capital due to government investments in social programs – for example, laws that keep the retail price of gasoline artificially low. And although technology for leading-edge exploration and production is global in nature, some NOCs lack experience in deploying it successfully, especially with unconventional resources such as shale or deepwater.

The revenue challenge has some NOCs recognizing the need to rethink existing fiscal regimes, as more favorable conditions for international oil companies (IOCs) would spur new interest and lead to new activity. Mexico, for example, restructured its fiscal regime and opened up its industry to outside participation. Many oil producing countries in South America, Africa and even the Middle East are also considering fiscal regime changes to attract investment.



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A better goal: stronger interdependence

For many of these countries, adapting the existing fiscal regime to today's price environment is the easiest lever to pull to increase oil revenues. Global commodity prices obviously can't be changed. And improving infrastructure to attract investment – for example, adding new pipelines to connect new producing regions with existing markets – is expensive and time-consuming. Without outside investment and involvement, rapid development faces too many barriers.

But changes to the fiscal regime are easy. Adjustments to royalty and tax rates and incentive offers – such as tax credits for new projects in high-cost areas – can be quickly implemented. In today's competitive market, these types of changes are a necessity, because there are more opportunities for investment than needed to meet global demand. With so many choices, capital will flow to countries with built-in advantages – such as favorable fiscal regimes, stable regulatory environments and solid infrastructure, all of which are important elements that IOCs take into account when making investment decisions.

Countries can also adopt new tax or capital market structures, such as master limited partnerships (MLPs) or real estate investment trusts, that are commonplace in the US. The MLP structure has played a major role in attracting investment to the type of midstream infrastructure projects that many developing countries need; it could create similar opportunities around the globe. Creative thinking around such a structure can attract new capital and provide access to capital markets for cash-starved NOCs.

Shift in thinking creates opportunity

For oil and gas companies, these countries' willingness to rethink their fiscal regimes presents a significant opportunity to negotiate far more favorable terms for new projects. Over the next few years, the environment for new deals will likely be better than it has been in a long time. That's welcome news for an industry that hasn't had a lot to cheer about recently.

For governments of oil-producing nations, there is a definite need to stay aware of the fiscal regime changes taking place around the world and to make adjustments as necessary to stay competitive. Being slow to respond to changing market conditions will mean losing out on new investment and falling further behind.

The decade ahead presents a new competitive environment for the industry, but the end result could be beneficial for both IOCs and their NOC partners around the world.

About *Frontiers*: in order to not just survive, but thrive, oil and gas companies and their executives must look around every corner, into the distance, to forecast the industry's next frontier. There are many weak signals that, if they gain velocity, could have major implications on the industry. But, what happens when companies are too busy managing the current environment, especially in today's low oil price landscape, to focus on the horizon? And how can companies prepare for those weak signals with an eye on the present and toward the future? Please follow along as we analyze different energy futures and weak signals impacting the industry regularly through our *Frontiers* series. If you are interested in receiving future editions of *Frontiers*, please contact **usenergy@ey.com**.

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