Answer-to-Question-_1_

1) Service contracts is one of 3 primary arrangements used by countries in exploration, development and production of oil and gas resources. The other two being concession and tax regime and production sharing contracts (or agreements). Service contracts are typically either a pure service contract or a risk service contract.

A pure service contract is a guaranteed fee and milestone based provided that the contractor meets the agreed upon milestones which in the case of Lucky Oil is tied to the depth of the potential oil well. In this type of contract the contractor is paid regardless of whether oil is discovered.

On the other hand, in a risk service contract, the contractor assumes some degree of discovery risk and in exchange stands to earn a risk premium if the project is successful (similar to success fees). However, the contractor also stands to incur significant losses if the project is unsuccessful.

In both cases, the government of Xantha shall retain full control of the oil fields but will be protected against exploration costs in case of failure but will enjoy the full benefit of the oil discovery which is not shared with Lucky Oil.

The major oil producing countries that use service contracts include Iran,Iraq and Saudi Arabia as well as Nigeria. These countries mainly use service contracts due to the fact that the availability of oil wells is more or less confirmed at the time of contracting but more data may be required in terms of volume, depth, quality and overall commercial viability of the wells. Some countries such as Mexico are reconsidering the service contract model because the model does not offer investment incentive for oil and gas companies.

2)

(a) In this scenario, Lucky oil will only be paid for the seismic study and the profit will be £100million less £35 million = £75million.

(b) In this scenario: Revenue (seismic study + drilling upto 150m) is £100 million + £250 million = £350 million. The corresponding expenses are (35m+110m) = 145 million. Profit = £350 million less £145 million = £205 million

(c) In this scenario, Revenue (seismic study + drilling upto 250 m)in addition to recovering its full costs. Revenue = £(100+150+200+200) = £650 million. Recovery of costs means that the costs amounting to £(35+50+120+80) = £275 million will be offset by the government. The result is a pure profit of £650 million which will be subject to 20% corporate income tax rate (£130 million in taxes) leaving a post tax profit of £520 million

Answer-to-Question-_2__

MNEs in the oil and gas industry often establish oil and gas trading ventures within the group structure for purposes of a more centrally or regionally co-ordinated approach to enhance direct access the global oil and gas (energy) market. These trading ventures allow an MNE to scale their marketing and sales operations and have direct access to energy customers or domnstream market by eliminating third party resellers or brokers.

Due to their strategic value to the overall profitability of the MNE, meticulous planning and structuring is required with respect to the location where the trading company is situated for various reasons inter-alia tax and other business and economic factors that are not within the scope of this question (e.g. Govt policy, exchange control, banking infrastructure etc.) With respect to the tax considerations, MNEs are naturally inclined to set up trading operations in low-tax jurisdictions such as switzerland, Singapore and the UAE. These countries have a wide tax treaty network and provide substantial incentives and exemptions to global trading companies on their foreign sourced global income e. g. Singapore provides a low tax rate of 10 percent which may be reduced further to 5 percent based on operational intensity and use of the financial center.

The trading companies purchase oil and gas from production companies in the MNE and on-sell to buyers in the global market leaving them with a high profit potential. In the context of international tax and in particular in the wake of BEPS, resource countries may be keen to ensure that the MNE has not artificially shifted profits to the low tax jurisdiction.

MNEs should therefore ensure that the trading company can demonstrate commercial substance in the following ways:

(i) constitution of the Board of Directors whereby more directors are resident in the jurisdiction and majority of board meetings where critical decisions take place in that jurisdiction.
(ii) In-country management and expertise - the group's oil marketing and sales experts that play a pivotal role in negotiations, sales planning and analyis should ideally be based in the country.
This ensures that the MNE is protected from domestic and treaty GAARs such as the principal purpose test, double residence issues

in case the place of effective management (or central management) is deemed to be in a different jurisdiction and also potential CFC rules based on lack of active business (US CFC) or

Another important tax issue is transfer pricing where resource jurisdiction may consider the sale price of its natural resources to be below the arm's length price or a buyer/market jurisdiction may consider the purchase price to be higher than the arm's length price. These potential disputes can be mitigated by ensuring proper transfer pricing documentation is maintained in accordance with the transfer pricing rules in the jurisdictions of operations. These rules generally follow the OECD TP guidelines. However, some countries may set a deemed price that is not the market price and the MNE will need to adjust appropriately. A potential dispute resolution tool is an Advance Pricing Agreement which may be unilateral, bilateral or multilateral.

Other tax and legal considerations to make include sanctions, double taxation etc.

The most common derivatives used in the oil and gas sector include:

a) Options - these are derivatives that give the holder the right but not the obligation to buy or sell a specific quantity of oil and gas at a predetermined price. Options are either put options (sell) or call options (buy). The gas trading entity may enter into an options contract with the producer company within the MNE for purposes of speculation but the two are not bound. When an option is exercised, a sale and purchase transaction occurs which in most jurisdictions is a taxed as business profits.

(b)Futures - Futures differ from options in that they are binding. In this case, the future price is locked and ensures that the producer and trading company are hegded from price volatility. The gains or losses arising from hedging are taxable in most jurisdictions but the difference arise as to the tax category (ordinary income or capital gains/losses)

(c) Swaps - these are derivatives where two parties exchange one type of cash flow for another. This mostly applies to financial instruments such as debt-swaps, currency swaps etc. Trading company may for instance exchange its dollars for Saudi riyals if they need to pay for oil in Saudi Arabia and later on swap when they receive dollars from customers.

(d) Forwards

Answer-to-Question-_6__

1) Ring fencing in oil and gas contracts refers to treatment of oil and gas projects separately in terms of commercial and tax treatment such that the profits or losses of one project are not combined with other projects or businesses of the oil and gas company in a particular jurisdiction.

Ring fencing may apply to particular oil blocks/fields covered under different licenses or onshore v offshore oil fields and in some cases different business activities in the value chain for example, upstream activities are not combined with midstream or downstream activities. Ring fencing applies in both tax and concession regimes as well PSA regimes.

2)

i) The tax implications of ring fencing on Oil & gas companies include:
a) Tax losses - The company is unable to offset exploration and drilling costs in an early stage project against profits in other later stage projects and in the event that a particular project does not reach commercial production/viability then those losses are effectively irrecoverable. This also applies in PSAs whereby the carryforward cost oil cannot be offset against profit oil in other projects.

(b) Transfer pricing - Transfer pricing issues arise especially in terms of allocation of shared costs that are attributable to different projects or technical services offered by the group. This is especially because the services income may be taxed in one group entity but the recovery/deductibility is deferred indefenitely.

(c) One advantage is that ring fencing may help in terms of cash flow planning since the financial model of a single project is simpler to administer than a combined project company.

(ii) The implication on government revenue is that governments are able to receive tax payments much sooner for projects that are further along when they are not allowed to offset losses from newer or more complicated projects. However, ring fencing may dissuade potential investors who are concerned that potential irrecoverable losses in case of an unsuccessful projects will not be cured by the tax law.

Answer-to-Question-__7_

Oil and gas MNEs finance their acquisitions or investments through equity and debt. Debt has advantages over equity due to lower cost of capital but also provides the MNE with an opportunity to use the interest payments as a profit repatriation strategy. Interest deductibility in oil and gas refers to the ability of an oil and gas company to deduct interest against taxable profits. For a long time, MNEs would claim substantially high interest deductions which led to countries to legislate interest deduction limitation rules including:

-Thin capitalisation rules which limit interest deductions up to a fixed equity or debt ratio.
- Fixed ratio rules where the deductible interest rule is fixed as a percentage of adjusted taxable profit (e.g. OECD recommends 30 percentage of EBITDA) and many countries have adopted this ratio)
- Transfer pricing - MNEs are required to provide justification that the interest rate used is consistent with the arm's length principle as part of a comparability analysis for comparable debt instruments.

Oil and gas MNEs have to determine the most optimal financing structure for acquisition of assets or shares of a target company. In most cases, setting up an SPV in the jurisdiction which then acquires assets of the target using third-party debt is straightforward for tax purposes since the interest on borrowing can be deducted against the income of the SPV with no restriction. Another approach is the MNE may borrow at a holding company level to finance the share acquisitions in the target entity which may not be efficient because the passive holding company may not have the tax capacity to absorb the interest deductions (i.e. the holding company either does not earn dividend income within a specific period for tax loss recovery or in most cases, the jurisdiction of the holdco has a participation exemption regime e.g. Netherlands, UK and US which exempts dividends and consequently does not allow deduction of expenses relating to exempt income).

Most acquisitions are share acquisitions and not asset acquistions which leaves the MNE with few options other than to push down the debt to the target entity (now acquired). The most common debt push down structure is to set up an SPV in the target's jurisdiction, the SPV borrows to acquire the shares in the target. In this scenario, the MNE may deduct interest if the jurisdiction allows for consolidated tax return or alternatively, the MNE may create a post-acquisition downstream merger between the SPV and the target Co with Target Co as the surviving entity such that it now assumes the debt e.g. in Brazil.

Answer-to-Question-_4__

An MNE may acquire an oil and gas license in various organisational frameworks including a subsidiary company, a joint venture (JV) or as a branch (PE). The branch structure is not common or acceptable to most jurisdictions but it is still possible.

The subsequent transfer or sale of an oil and gas license for restructuring purposes has various tax implications that require consideration. These considerations are driven to a large extent by the structure of the holder of the license.

In this question, we shall consider the following tax considerations:

a) Capital gains tax - capital gains on gas licenses arises when the license is sold at a profit. In this case, if a local subsidiary makes the sale, it could potentially offset the capital gains taxes from any losses accrued over the time the licenses were held and the residual amount is repatriated to the MNE.

However, a joint venture organised as a partnership may result in the CGT being taxed on the partners in a different jurisdiction which may potentially create double taxation issues.

b) Corporate income tax
c) Withholding tax
d) Other exit taxes including stamp duties etc.