Ukraine | Research
Energy
Desk Note

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Independent gas producers

New legislation stimulates gas field development

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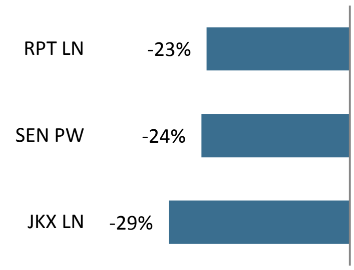
Market price change since Jul.18



Source: Bloomberg

The amendments to the tax code, which were made public on August 2, offer more negatives than advantages for independent natural gas producers operating in Ukraine. At the same time, we believe the market reacted too harshly to the regulatory changes as traders have plundered the shares of gas producers by 23%-29% since July 18, a day before the tax hikes were initially revealed. Firstly, the increases could have been much worse (the initial proposal assumed a much higher tax, to be applied indefinitely). Secondly, the tax hike is temporary and the new legislation creates opportunities for firms to decrease the average tax burden starting in 2015 by investing in new wells.

Effective as of Aug. 3, the changes to the production-based tax for gas production are:

- An interim increase of the tax rate from 28% (15% for gas extracted from wells deeper than 5km) to 55% (28% for those deeper than 5km) between Aug. 3 and Dec. 31, 2014.
- A permanent change in the basis for the application of the tax rate. Earlier, the tax was applied to the average price of imported gas (calculated each month by the Economy Ministry). Now it is applied to a regulated price ceiling for gas (set by the National Electricity Regulation Commission). This raises the base for tax application by about 1.6x, compared to 1H14. For instance, the average price for imported gas was USD 275/tcm in 7M14 (or UAH 2,940/tcm), while the regulated price ceiling is UAH 4,724/tcm at the moment.
- An application of a 0.55x multiplier to calculate the production-based tax for gas produced by new wells (commissioned after Aug. 1, 2014). The regulation will be applied for the first two years of operation of any new well.

Note that the approved changes are much simpler compared to what was proposed in the initial bill made public on July 21, such as the application of a 70% production tax for all gas wells, without any exception and with no time limits.

The increased tax burden to harm operating profit in 2014

The approved legislation will increase production-based tax for most gas producers to 56%-59% of their achieved gas price in August-December 2014, up from 20%-22% of the price in 7M14. This will increase the tax burden for the listed gas producers for the period to (assuming an average UAH 11/USD exchange rate and no changes in domestic gas prices):

- USD 24.0 mln for JKX Oil & Gas (vs. USD 7.5 mln previously). The net tax increase will reduce the company's operating profit 25% in 2014, compared to the no-increase case, we estimate;
- USD 29.7 mln for Serinus Energy (vs. USD 9.5 mln). The net increase in tax will eat away at 22% of the company's operating profit in 2014, while profit will remain flat yoy, we estimate;
- USD 2.8 mln for Regal Petroleum (vs. USD 1.2 mln). The net increase in tax will halve the company's operating profit in 2014, we estimate.

We believe the market's negative reaction to new legislation was too harsh, given that the negative effect of the new taxation on the profits of gas producers will be short-lived.

New wells to reduce average tax burden as of 2015

As of January 2015, the royalty tax burden will decrease to 29%-30% of the gas price for most gas producers (and to about 16% for Regal), we estimate. Moreover, given that new wells will be taxed less, the companies that will produce more than 30% of their gas from these new wells will face an even smaller average tax rate on their gas in 2015, as compared to 2013.

Serinus Energy which is planning to drill new wells in Ukraine has a good chance to reduce its average tax burden in the coming two years below its 2013 level.

For Regal Petroleum, which focuses on deep (and thus more expensive) wells, its increased tax burden will be minimal. And the effect of new wells on its average tax burden will be smaller.

Estimated royalty for natural gas

	2013	7M14	Aug-Dec'14	2015
SEN PW, JKX LN, CAD LN:				
Royalty, old wells UAH/tcm	816	812	2598	1323
% of achieved gas price	24% - 26%	20% - 22%	56% - 59%	29% - 30%
Royalty, new wells UAH/tcm	816	812	1429	727
% of achieved gas price	24% - 26%	20% - 22%	31% - 32%	16% - 17%
RPT LN (wells deeper than 5km):				
Royalty, old wells UAH/tcm	457	432	1323	709
% of achieved gas price	14%	12%	29%	16%
Royalty, new wells UAH/tcm	457	432	727	390
% of achieved gas price	14%	12%	16%	9%

Source: Verkhovna Rada, NERC, Economy Ministry, Concorde Capital estimates

New rules demand strategic review of E&P operations, imply new risks

The new taxation rules might have an important influence on the strategies of Ukraine-based gas producers, including:

- Tax-related decreases in the NPV/IRR of existing wells may result in a downward revision of their total production plan. In particular, they might make the “old” wells’ overhauls inefficient. This might lead to decreases in total gas reserves/resources. The changes will be minimal, we believe.
- The decreased tax burden for the new wells might result in the firms refocusing on drilling new wells from stimulating gas flow at old wells. In the short term, this may lead to a slower growth in gas production, compared to the companies’ initial plans.
- The two-year period of low taxation of new wells will stimulate companies to increase gas flow from such wells as soon as the reduced taxes take effect. While this might lead to a faster increase in gas production on the horizon one to two years from now, such tactics will increase the risk of the new wells’ failure caused by an abnormally high extraction rate, e.g. by causing water intrusion.

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