Adjustment of the Parameters of the "Damping Mechanism" in the Oil Industry for the Second Half of 2019 and Subsequent Periods

On 30 July the President of Russia signed a federal law[1] amending the provisions of the Tax Code relating to the "damping mechanism" that is currently used to stabilize prices for oil products on the domestic market by curbing the impact of global oil prices on domestic retail prices.

The new law makes adjustments to the parameters of the damping mechanism applicable in calculating excise duty on petroleum feedstocks (effective from 1 July 2019), counterbalanced by changes relating to the adjustment of MET on oil (effective from 1 October 2019). In addition to the "damper" for motor fuels, the law introduces similar provisions for jet fuel with effect from 1 August 2019 and revises the definition of "medium distillates".

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[1] *Federal Law No. 255-FZ of 30 July 2019*

Main Changes

The key change made by the law is the updating of the "damping mechanism", which enables oil companies to be partially compensated for lost profit arising from supplies of motor fuel to the domestic market where export prices exceed notional domestic prices. In the reverse scenario, the mechanism would conversely compensate the state for a shortfall in revenue.

The law makes the following adjustments to the parameters of the damper:

▶ additional restrictions are placed on the use of the mechanism depending on the situation on the domestic market for motor fuels: the "damper" is applicable if domestic wholesale prices exceed notional prices by more than 10% in the case of petrol and by more than 20% in the case of diesel (as opposed to 10% previously)

▶ the notional average domestic wholesale prices for petrol and diesel set by the Tax Code are reduced in the period from 1 July 2019 to 31 December 2024, thereby expanding the "positive framework" for the operation of the damper. In particular, for the period from 1 July to 31 December 2019 the petrol price is lowered from 56,000 to 51,000 roubles per tonne (41 roubles per litre at the filling station), and the diesel price from 50,000 to 46,000 roubles (41.75 roubles per litre at the filling station). Those prices will increase by 5% annually

▶ the compensatory coefficient is to rise from 0.6 to 0.75 for petrol and 0.7 for diesel in 2019, and from 0.5 to 0.68 for petrol and 0.65 for diesel from 2020 onwards

▶ oil companies that sell motor fuel produced from petroleum feedstocks through delivery bases in the Far Eastern Federal District (a list of delivery bases is to be established by the Russian government) will qualify for an additional damper amounting to 2,000 roubles per tonne. If wholesale petrol and diesel prices in that region deviate from Russia-wide prices by more than 20%, the "Far Eastern increments" will be reduced to zero

As well as modifying the damper for motor fuels, the law addresses the growth in the cost of jet fuel over the last few years by adjusting the current mechanism to support air carriers (the right to deduct excise duty with a multiplier of 2.08 applied). The reverse excise duty established by the law for jet fuel compensates airlines for some of their fuel expenditure while leaving the price unaffected. Airlines will be able to apply the damper only if global market conditions lead to price rises on the domestic market. The jet fuel damper is expected to take effect from 1 August 2019.

According to the explanatory note for the law, the shortfall of federal budget revenue resulting from the above measures is to be made up partly by classing all dark oil products (including fuel oil and marine fuel) as medium distillates from 1 April 2020 and by modifying the procedure for the calculation of the coefficient C_{PTDS} which is used in calculating the MET rate for oil.

The law also revises the definition of "medium distillates" and alters the procedure for calculating the deduction applicable when they are taken out of the country as stores on marine vessels. To prevent the same product being taxed twice, the law removes references to "dark marine fuel" and related objects of taxation and deductions.

We will now take a more detailed look at the changes made by the law.

Determination of the Deduction Applicable When Calculating Excise Duty on Petroleum Feedstocks

Petroleum feedstocks were introduced as a new excisable product from 1 January 2019, along with the mechanism for calculating excise duty on petroleum feedstocks and the procedure for applying a deduction using a multiplier (see Tax Messengers dated 15 November 2018, 13 July 2018 and 30 June 2018). Specifically, deductions may by claimed for amounts of excise duty multiplied by 2 ("negative excise duty") and increased by the value of C_{DAMP} (the "damping coefficient") subject to certain conditions being met and required documents being submitted.

The law amends the procedure for calculating the damping coefficient:

$$C_{DAMP} = D_{PT} \times V_{PT} \times C_{PT\_COMP} + D_{DS} \times V_{DS} \times C_{DS\_COMP} + D_{FE\_PT} \times V_{FE\_PT} + D_{FE\_DS} \times V_{FE\_DS},$$

where:

D_{PT} and D_{DS} represent the difference between the average price of the export alternative and the notional average wholesale price for class 5 petrol and class 5 diesel respectively.

V_{PT} and V_{DS} are the volumes of high-octane class 5 petrol and class 5 diesel respectively produced from petroleum feedstocks and other raw materials in relation to which excise duty has been calculated. The volume of other raw materials used must not exceed 10% of the total volume. The law also states that the figures in question are to be reduced by volumes of returned petrol and/or diesel in the tax period in which the return occurred.

C_{PT_COMP} and C_{DS_COMP} are set at 0.75 and 0.7 for 2019 and 0.68 and 0.65 for 2020 respectively.

V_{FE_PT} and V_{FE_DS} are the volumes of class 5 petrol and class 5 diesel sold through delivery bases situated in the Far Eastern Federal District according to a list of such delivery bases to be established by the Russian government.

D_{FE_PT} and D_{FE_DS} are Far Eastern increments, to be calculated by the taxpayer itself as follows:

$$D_{FE\_PT} = 2,000 + D_{PT}$$

$$D_{FE\_DS} = 2,000 + D_{DS}$$

In this regard:

▶ D_{FE_PT} and D_{FE_DS} cannot be greater than 2,000 or less than 0 (if the value is found to be less than 0, it is taken as equal to 0)

▶ D_{FE_PT} and D_{FE_DS} are taken to be zero if the average wholesale price for the tax period for the sale of class 5 petrol and class 5 diesel through delivery bases in the Far Eastern Federal District deviates by more than 20% from the average wholesale price for Russia as a whole

P_{PTdm} and P_{DSdm} are the notional values of the average wholesale prices of class 5 petrol and class 5 diesel in Russia, which are taken as having the values shown in the table below for a particular year (roubles/tonnes):

Year	2019	2020	2021	2022	2023	2024
P_{PTdm}	51,000 (previously 56,000)	53,600 (previously 58,800)	56,300 (previously 61,740)	59 000	62 000	65,000
Change (petrol), %	-	5.1%	5%	4.8%	5.1%	4.8%
P_{DSdm}	46,000 (previously 50,000)	48,300 (previously 52,500)	50,700 (previously 55,125)	53 250	56 000	58,700
Change (diesel), %	-	5%	4.9%	5%	5.2%	4.8%

C_{DAMP} is taken to be zero:

▶ if the average wholesale price for sales of class 5 petrol and class 5 diesel in Russia deviates by more than 10% and 20% respectively from the values of P_{PTdm} and P_{DSdm}

▶ if P_{PTdm} and/or P_{DSdm} have not been set for a tax period

The amending law excludes from the damper calculation formula the compensatory increments for petrol and diesel (F_{PT} and F_{DS}), which were previously introduced to form a "positive framework" for the operation of the damper. However, the values in question remain in place for the calculation of MET on oil.

Overall, despite a number of specific issues, the damper mechanism is a viable approach to the striking of a balance in the "state – companies – consumer" triad, allowing for benefits and risks to be distributed among the different parties.

The lowering of notional wholesale prices (it should be pointed out that the values stated in the law are those proposed at the very start of the process of developing the mechanism), coupled with the elimination of F_{PT} and F_{DS}, serves to iron out the abrupt price disparity ("price bump") triggered by the crossing of a "fixed boundary". The reduction of notional prices for both kinds of fuel (by 5,000 Rbs/tonne for 2019) effectively affords companies the same benefit as the compensatory increments, but in a "smoother", more gradual form, thus expanding the "positive framework" for the application of the damper.

The inclusion of the Far Eastern increments in the revised rules for the damping mechanism makes the damper more effective for the Far Eastern Federal District, since it takes account of regional factors affecting demand and supply and price movements.

In addition, the increase in the amount by which the actual wholesale price may deviate from the "fixed" level in the case of diesel fuel may

reduce potential risks for the domestic market in the winter period, when the cost of fuel rises significantly owing to the use of additional additives.

Adjustment of MET on Oil

Under changes in the calculation of MET on oil which took effect from 1 January 2019, a new coefficient (C_{PTDS}) was added to the formula for the calculation of MET:

$$MET_n = 919 \text{ Rbs/t} \times C_P - [559 \text{ Rbs/t} \times C_P \times (1 - C_D \times C_{DE} \times C_{DV} \times C_R \times C_{CAN}) - C_C - C_{PTDS} - C_{MAN} \times C_{VO}]$$

The amending law inserts a new summand in the formula for the calculation of C_{PTDS} and modifies the procedures for calculating the coefficients N_{PT} and N_{DS}:

$$C_{PTDS} = N_{PT} \times I_{PT} + N_{DS} \times I_{DS} + N_{BUG},$$

where:

N_{PT} and N_{DS} are coefficients representing increments for petrol and diesel and are taken to have the values shown in the table below for the relevant period:

Period	From 1 January to 30 September 2019	From 1 October to 31 December 2019	From 1 January 2020
N_{PT}	125	200 (previously 125)	105
N_{DS}	110	185 (previously 110)	92

I_{PT} and I_{DS} are binary coefficients for class 5 petrol and class 5 diesel and take the value:

▶ 0 if $D_{PT\_S} / D_{DS\_S} \leq 0$

   (i.e. if the notional wholesale price on the domestic market exceeds the export netback);

▶ 1 if $D_{PT\_S} / D_{DS\_S} > 0$
   (i.e. if the export netback exceeds the notional wholesale price on the domestic market).

D_{PT_S} and D_{DS_S} take the following values:

Indicator	From 1 January to 31 December 2019[2]	From 1 January 2020
D_{PT_S}	= D_{PT}	$P_{PTexp} - P_{PTdm\_S,}$
D_{DS_S}	= D_{DS}	$P_{DSexp} - P_{DSdm\_S,}$

P_{PTdm_S} and P_{DSdm_S} are cut-off coefficients for petrol and diesel which are taken to have the values shown in the table below for the relevant year (Rbs/t):

Year	2020	2021	2022	2023	2024
P_{PTdm_S}	58,800	61,740	64,827	68,068	71,472
P_{DSdm_S}	52,500	55,125	57,881	60,775	63,814

The mechanism for calculating the export alternative (P_{PTexp} and P_{DSexp}) is the same as in the current version of the Tax Code.

The amending law provides for a coefficient N_{BUG} representing an increment for the change in the damper mechanism to be applied from 1 January 2020 in the calculation of C_{PTDS}:

$$N_{BUG} = (N_{C\_DAMP} - S_{C\_DAMP}) \times (37.5/484) + D_{FE\_PT} \times (2/484) + Д_{FE\_DS} \times (3.7/484) - 124,$$

where:

N_{C_DAMP} is a coefficient reflecting the damper after 2020:

$$N_{C\_DAMP} = D_{PT} \times C_{PT\_COMP} + D_{DS} \times C_{DS\_COMP};$$

S_{C_DAMP} is a coefficient reflecting the damper before 2020 (i.e., the difference between the damper mechanism before and after 2020 is determined):

$$S_{C\_DAMP} = (D_{PT\_S} + F_{PT} + D_{DS\_S} + F_{DS}) \times (1/2),$$

where:

F_{PT} and F_{DS} are fixed components for class 5 petrol and class 5 diesel, which take the following values:

Condition	F_{PT}	F_{DS}
$D_{PT\_S}, D_{DS\_S} < 0$	0	0
$D_{PT\_S}, D_{DS\_S} \geq 0$	5,600	5,000

(i.e. if the export netback exceeds the notional wholesale price on the domestic market).

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[2] *Taking into account the new/reduced values of notional domestic fuel prices*

For the purpose of calculating MET, N_{BUG} is taken to be zero if its calculated value is less than zero.

Deduction of Excise Duty on Jet Fuel

In a similar manner to the damping mechanism for motor fuels, the amending law gives aircraft operators the right to claim an excise duty deduction for jet fuel received (in addition to the existing right to deduct excise duty using a multiplier, which has been set at 2.08 since 1 January 2017).

Specifically, an additional summand (V_{AVIA}) is introduced in determining the amount of deductible excise duty on jet fuel received ("reverse excise duty"). It comes into play when global oil prices are at a high level (meaning, according to the explanatory note, when they rise above 70 USD/barrel), depending on the difference between the average price of the export alternative for jet fuel and the notional average domestic wholesale price for jet fuel.

The value V_{AVIA} is to be determined by the taxpayer itself using the following formula:

$$V_{AVIA} = D_{JF} \times V_{JF} \times C_{DS\_COMP},$$

where:

V_{JF} is the volume of jet fuel received that was used in the tax period by the taxpayer itself and/or by a person with whom the taxpayer has concluded a contract for the provision of aircraft refuelling services;

C_{DS_COMP} is equal to 0.6 for 2019 and 0.5 for 2020;

$$D_{JF} = P_{JFexp} - P_{JFdm};$$

where:

P_{JFexp} is the average price of the export alternative for jet fuel in seaports of the North-Western Federal District:

$$P_{JFexp} = ((P_{JFrt} - T_{DSm} - ED_{JF}) \times R) \times (1 + R_{VAT}),$$

where:

P_{JFrt} is the average price of jet fuel on the Rotterdam petroleum market for the tax period in USD/tonne;

T_{DSm} represents average costs for the tax period for transport by sea and transhipment in ports per tonne of class 5 diesel fuel from Russian seaports situated in the North-Western Federal District to the Rotterdam petroleum market in USD/tonne;

ED_{JF} is the rate of export duty for jet fuel in USD/tonne;

R is the average value of the USD-rouble exchange rate set by the Central Bank;

R_{VAT} is the rate of VAT;

P_{JFdm} is the notional value of the average wholesale price for sales of jet fuel in Russia, which is taken to have the values stated in the table below according to the year (Rbs/tonne):

Year	2019	2020	2021	2022	2023	2024
P_{JFdm}	48 300	50 700	53 250	55 900	58 700	61 600
Change, %	-	4.9%	5%	4.9%	5%	4.9%

The procedure for calculating P_{JFrt} and the value of P_{JFexp} are to be established by a federal executive body. If the procedure for calculating P_{JFrt} has not been established by the 15th of the month immediately following a tax period, the value of P_{JFrt} is taken to be zero for that tax period.

D_{JF} is taken to be zero for the purposes of calculating the deduction if the calculated value of D_{JF} is less than zero and/or the value of P_{JFdm} has not been set.

As in the case of excise duty on petroleum feedstocks, a number of the above-mentioned coefficients are to be calculated and communicated to taxpayers by the Federal Anti-Monopoly Service.

Revision of the Definition of "Medium Distillates" and the Related List of Processing Operations for Excise Duty Purposes

Under the amending law, for excise duty purposes medium distillates are defined as mixtures of hydrocarbons in liquid or solid state (given a temperature of 20 degrees Celsius and an atmospheric pressure of 760 millimetres of mercury) that are obtained as a result of the primary and/or secondary processing of oil, gas condensate, associated petroleum gas and oil shales and have a density of not more than 1,015 kg/m^3 (previously 930 kg/m^3) given a temperature of 20°C.

The list of products not classed as medium distillates is extended by the addition of the following items to the exceptions specified in subsection 11 of clause 1 of Article 181 of the Tax Code:

- Jet-1 aviation fuel

- gas condensate and oil and gas condensate mixture obtained directly using deethanization and/or stabilization and/or fractionation processes (provided that the fractionation process is combined with the deethanization and/or stabilization process)

- oil, bitumen, asphalt, coke, carbon black, sulphur

In addition, petroleum feedstocks are not classed as medium distillates where any of the following conditions is met in relation to operations involving them:

- the petroleum feedstocks are sold (transferred) by a subsurface user organization, provided that the petroleum feedstocks were obtained from a commercial mineral extracted by the subsurface user

- petroleum feedstocks obtained as a result of the processing of petroleum feedstocks are subsequently sold (transferred) by the organization that owns the processed petroleum feedstocks, which holds a certificate of registration of a person that carries out petroleum feedstock processing operations, mixed with petroleum feedstocks which are an extracted commercial mineral for that organization and/or with petroleum feedstocks which that organization acquired from subsurface user organizations for which those petroleum feedstocks are an extracted commercial mineral, provided that that mixture is transported by trunk pipeline

- the petroleum feedstocks are sold (transferred) by one organization holding a certificate of registration of a person that carries out petroleum feedstock processing operations to another organization holding that certificate and/or a certificate of registration of a person

that carries out medium distillate processing operations, provided that the feedstocks are subsequently processed by that other organization, including on the basis of a contract for the provision of petroleum feedstock processing services to that organization

- petroleum feedstocks when supplied for processing by an organization holding a certificate of registration of a person that carries out petroleum feedstock processing operations using production facilities belonging to that organization or to an organization that directly provides petroleum feedstock processing services to that organization, including on the basis of a contract for the provision of petroleum feedstock processing services to that organization

- petroleum feedstocks when received/recorded as received by an organization holding a certificate of registration of a person that carries out medium distillate processing operations and/or a certificate of registration of a person that carries out petroleum feedstock processing operations if they are subsequently processed by that organization, including on the basis of a contract for the provision of petroleum feedstock processing services to that organization

In addition, the following processes are added to the list of medium distillate processing operations required to obtain a certificate:

- delayed coking

- hydroconversion of heavy residues

- obtaining of carbon black by means of the thermal or thermo-oxidative degradation of medium distillates

- production of bitumen by means of the oxidation of tar

The law also introduces additional criteria for defining high-viscosity products, which remain excluded from the scope of "medium distillates".

Exclusion of "Dark Marine Fuel"

In connection with the revised definition of "medium distillates" and to prevent the same products from being taxed twice, the law

excludes the term "dark marine fuel" and the related object of taxation and deduction.

Deduction of Excise Duty Using a Multiplier in Relation to Operations Involving Medium Distillates

In connection with the revised definition of "medium distillates" and the exclusion of "dark marine fuel" as an excisable product, the law inserts a new summand, V_{DFO}, in the formula for the deduction applicable when medium distillates are taken out of the country as stores on marine vessels.

$$V_{DFO} = C_{DFO} \times V_{sales},$$

where:

V_{sales} is the volume of sales in a tax period, by an organization included in the register of suppliers of bunker fuel (licensed to carry out handling activities), of medium distillates conveyed out of Russia as stores on marine vessels.

C_{DFO} is a coefficient reflecting regional factors involved in the production of medium distillates.

For medium distillates owned and produced by an entity that is located in the Khabarovsk Territory and has a certificate of registration, or produced on a toll basis, the value of C_{DFO} is taken to be equal to:

▶ 2,100 – until 2021 inclusively

▶ 1,100 – commencing from 2022

▶ For other entities, $C_{DFO} = 0$.

It should be pointed out that in the current version of the Tax Code a similar summand features in the calculation of the excise duty rate for dark marine oil and, therefore, in the determination of the tax deduction. This change does not, therefore, constitute a new development in tax law, but is prompted by the changes in the definitions of oil products.

Other Changes

To prevent an increase in the tax burden on heat and power suppliers that use medium distillates as fuel, the amending law extends the list of cases in which a coefficient of 2 may be applied in calculating the excise duty deduction for medium distillates to include cases where they are used as fuel in the production of electrical and thermal energy (at present, the coefficient only applies where they are used for bunkering). It should be pointed out that the purpose of granting the double deduction is to compensate for the absence of a tax exemption for a number of operations involving medium distillates (such an exemption exists, in particular, for jet fuel and petroleum feedstocks).

The amending law also provides for the exclusion from the profits tax base of income and expenses of an agent of the Russian Federation which arise in connection with the performance of functions under the law "On the Promotion of the Development of Housing Construction".

Entry into Force

The above-mentioned amendments to tax law will enter into force as follows:

▶ the damper for petroleum feedstocks – from 1 July 2019

▶ the damper for jet fuel – from 1 August 2019

▶ the adjustment of MET on oil – from 1 October 2019

▶ the definition of "medium distillates" and the calculation of excise duty thereon – from 1 April 2020.

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