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Committee Secretary
Standing Committee on Economics
PO Box 6021
Parliament House
CANBERRA ACT 2600

Submission via email: economics.reps@aph.gov.au

Dear Committee Secretary

INQUIRY INTO TAX DEDUCTIBILITY

This submission to the Standing Committee on Economics is made by INPEX Holdings Australia Pty Ltd on behalf of all the INPEX Group of companies within Australia.

INPEX Holdings Australia Pty Ltd, (**INPEX**), is making this submission in response to the terms of reference issued on 2 December 2015.

This submission focuses only on the company income tax system and not the personal tax system. Furthermore, in framing its response, INPEX has chosen to focus on how changes to certain elements in the tax system would impact on our business including changes to the Investment Rate of Return (**IRR**) and Net Present Value (**NPV**), which is the primary means on which INPEX assesses investment decisions.

If you would like further information on this submission please do not hesitate to contact John Williams.

Seiya Ito
President Director, INPEX Australia

1. INPEX

INPEX CORPORATION is a global oil and gas Exploration & Production (**E&P**) company that is listed on the Tokyo Stock Exchange and is owned 18.9 percent by the Japanese Government.

Since INPEX commenced operations in Australia in 1986, it has invested billions of dollars in exploration, development and production projects. Currently within Australia, INPEX's main producing assets are:

- a 47.499% stake in the Van Gogh oil field off Western Australia operated by Quadrant Energy Corporation;
- a 28.5% stake in the Ravensworth oil field off Western Australia operated by BHP Billiton Petroleum Pty Ltd; and
- a 47.499% stake in the Coniston Unit oil field off Western Australia operated by Quadrant Energy Corporation.

By virtue of the Timor Sea Treaty that governs the Joint Petroleum Development Area between Australia and Timor-Leste, INPEX also maintains:

- a 11.378120% interest in the Bayu-Undan oil, Liquefied Petroleum Gas (**LPG**) and natural gas development operated by ConocoPhillips;
- a 19.2458049% interest in the permit JPDA03-12 of which ConocoPhillips is the operator; and
- a 35% interest in the Kitan oil field operated by Eni S.P.A.;

of which 10% of the income and expenditures are attributed to Australia for taxation purposes.

Lastly, INPEX holds an 11.378120% interest in Darwin LNG Pty Ltd, the owner of the pipeline from the Bayu-Undan field and the processing plant at Darwin of which all of the income and expenditures are attributed to Australia for taxation purposes.

In addition to the current operating projects in Australia, INPEX also has interests in two projects currently being developed – a 62.245% interest in the Ichthys Liquefied Natural Gas (**LNG**) Project which INPEX operates and a 17.5% interest in the Prelude Floating LNG (**FLNG**) Project operated by Shell Developments (Australia) Pty Ltd (**Shell**). Additionally, INPEX supports a new ventures and exploration program within Australia and currently has interests in 13 exploration permits, six as operator.

<u>The Ichthys LNG Project</u>

On 13 January 2012, INPEX and its joint venture participant Total, made a Final Investment Decision (**FID**) with respect to the Ichthys LNG Project. Ichthys is a condensate and gas field located in the Browse Basin off the Western Australian coast with resource estimates of approximately 500 million barrels of condensate and 12 trillion cubic feet of gas. Hydrocarbons from the Ichthys field will undergo preliminary processing on a semi-submersible offshore Central Processing Facility (**CPF**) to remove water and raw liquids, including the greater portion of the condensate. The removed condensate will be pumped to a FPSO[1] facility anchored nearby. The gas and any remaining condensate will be transported from the CPF, via an 889 kilometre long pipeline to LNG processing facilities in Darwin.

The Ichthys LNG Project is expected to produce 8.4 million tonnes of LNG and 1.6 million tonnes of LPG per annum, along with approximately 100,000 barrels of condensate per day at peak.

Condensate produced offshore will be shipped directly from the field to international markets and feed gas piped to Darwin for processing into LNG and LPGs.

At FID, the total estimated cost of the Ichthys Project amounted to USD 34 billion and first gas is planned to commence in the third quarter of 2017. INPEX's investment in the Project at FID is the single biggest investment by a Japanese company ever into Australia. It is also the second biggest stand-alone resources project developed in Australia behind Chevron's Gorgon LNG Project. The Ichthys LNG Project is expected to provide a long-term stable supply of cleaner energy to North Asian markets, most notably Japan and Taiwan, and to help those nations diversify their energy sources.

The Ichthys LNG Project is expected to operate for 40 years and contribute significantly to the Australian economy, principally through income tax and Petroleum Resource Rent Tax.

[1] Floating Production, Storage and Offtake

Other key facts highlight the Ichthys LNG Project's contribution to the Australian economy:

- Nearly A$13 billion in contract commitment to Australian businesses
- 51 Aboriginal and Torres Strait Islander businesses and A$100 million in contract commitments
- More than 800 ATSI peoples have been engaged on the project to date
- 1000 NT businesses have been contracted to the project
- Peak construction workforce of 8000 is projected in the Northern Territory
- Operational life of more than 40 years

The contribution of the Ichthys LNG Project to the Northern Territory economy has been so significant it has secured top spot on Commsec's 'State of the State's' economic performance report and, to date, this region remains amongst the top performing economies, ranking number three in the October 2015 report.

In addition to the direct financial contribution, the Ichthys LNG Project will also contribute to the Australian economy through employment both directly on the Ichthys LNG Project and indirectly through engagement with other contractors, maintenance and service providers located in Australia.

Importantly, the FID decision represents a two train LNG facility at the Darwin processing plant, although this location is capable of accommodating another four LNG trains (gas plant production facilities). Such expansion could see output move to 25 million tonnes of LNG per annum. Any expansion of the Ichthys processing facilities would represent a significant investment into Australia and further contribution to the local and national economies.

Prelude

On 16 March 2012, INPEX Corporation announced that it had acquired a 17.5% interest in the Prelude FLNG Project from Shell, a subsidiary of Royal Dutch Shell PLC[2]. The Prelude FLNG Project consists of the Prelude and Concerto gas fields which will produce at least 3.6 million tonnes per annum of LNG along with 0.4 million tonnes per annum of LPG and 36 thousand barrels per day of condensate at peak.

Shell made the FID for Prelude in May 2011 with target production in early 2017. The forecast cost for the Prelude project is USD 12 billion and accordingly will contribute more than USD 2.1 billion to the cost of development through its participating interest. As with the Ichthys Project, Prelude will contribute significant tax revenues to the Australian Government and be a major employer both directly on the project and indirectly through maintenance and supply contracts.

The Prelude FLNG facility will be permanently moored for a 25 year period and then would be capable of being moved to other fields, which ordinarily may be considered as geographically or economically stranded and thus unlikely to be developed by other means.

[2] Media Release: INPEX participates in the Prelude FLNG Project, offshore Australia; 16 March 2012; Available: http://www.inpex.co.jp/english/news/pdf/2012/e20120316-b.pdf

2. GENERAL COMMENTS REGARDING THE TERMS OF REFERENCE

INPEX understands that the Committee will examine some options to simplify the personal and company income tax system, with a particular focus on options to broaden the base of these taxes in order to fund reductions in headline rates. INPEX notes in the terms of reference for the company income tax system component of the review, the reference to the deductibility of interest incurred by businesses in deriving their business income.

INPEX is a member of the Australian Petroleum Producers and Exploration Association (APPEA) and this submission supports APPEA's comments in its recent submission, along with those of the Corporate Taxpayers Association, to this taxation inquiry.

Regarding its own submission, INPEX has opted to focus its comments on two major areas currently considered as 'concessional' and accordingly potential base broadening options for the Committee, being the uniform capital allowance provisions and interest. Regarding exploration, another major area, INPEX fully supports APPEA's comments on that matter and does not presently have anything further to add.

Prior to discussion on these items, it is necessary to understand the process for investment decision making within INPEX. As a global company, potential Australian projects are assessed against a portfolio of other opportunities worldwide. Assessing cash flows on an after tax basis is a reliable means of determining where to invest. As such, INPEX evaluates all projects on an IRR/NPV basis. Other factors such as stability, sovereign risk, local operating conditions and strategic fit to the business are also considered.

Corporate taxation is a cash outflow in any IRR/NPV calculation and reduces the overall project returns accordingly. In most cases where the overall project returns are below a hurdle rate, a decision is taken not to invest.

As a publicly traded company, INPEX Corporation has an obligation to its shareholders to invest in the projects that deliver the highest rates of return. The global trend of reducing corporate tax rates will improve project rates of return in those jurisdictions, in some cases significantly; for example projects in the UK where the tax rate is 20%, moving to 18% by 1 April 2020. Similar projects in countries with lower tax rates than Australia can expect to achieve a higher rate of return and thus place Australia at a competitive disadvantage for attracting investment.

INPEX understands the issue for the Australian government is that the global trend of reduced corporate tax rates will put pressure on Australia to follow suit if it wishes to continue to attract foreign investment as ultimately the country is a capital importer, and in the absence of foreign direct investment, the economy will decline. It is further noted that many of these Governments did not undertake a base-rate trade off. Accordingly, the Committee should ensure it gives appropriate consideration as to whether base broadening to fund a cut will actually help competitiveness given the tax regimes of competitor countries still include a number of concessional treatments.

Overall, INPEX acknowledges that ultimately the setting of tax rates is a matter for government, but hopes that its comments below are useful to the Committee in terms of understanding the potential impacts on mega-projects, such as the Ichthys LNG Project.

Business Tax Working Group

The terms of reference of this Committee are similar to those of the Business Tax Working Group (**BTWG**) headed up by now Commissioner of Taxation Chris Jordan AO. The BTWG also looked at base broadening options that may enable the headline corporate tax rate to fall from 30%. Ultimately a large number of the remaining 'concessions' in the tax acts that were considered as broadening options by the BTWG were specific policy measures, designed for capital intensive, high risk enterprises. INPEX noted in its submission at the time that the proposal of the BTWG was not a typical tax cut but was actually a form of redistribution policy. Overall, in INPEX's opinion, a disproportionate amount of the funding was likely to come not from a broad base so as to spread the "losers" but from a handful of capital intensive sectors of which the oil & gas industry was one sector.

INPEX concluded in its submission that it would rather have no tax rate cut at all given the significant risk the base broadening measures posed to the Ichthys LNG Project, any possible future expansions of this project and to oil and gas projects in general. This was the result of internal project modelling suggesting a tax rate of 25% achieved neutrality for the Ichthys LNG Project, a rate unlikely to be obtained. Accordingly it was exceedingly likely that large capital intensive projects would instead be subsidising tax cuts for smaller enterprises. This position had serious impacts on the cash flows of the Ichthys LNG Project particularly given the fact the project is Project Financed by a large external lender group that includes banks and government export credit agencies.

INPEX notes that ultimately the BTWG concluded that it was not possible to achieve a corporate tax rate cut via base broadening.

Changing Dynamics of the Oil & Gas sector

When INPEX took FID on the Ichthys LNG Project on 13 January 2012, the price of oil was around USD100 per barrel. Since this date the oil price has fallen dramatically and currently sits at less than USD40 per barrel. Analysts believe that due to high stock levels and reduced export restrictions applicable in Iran, that the price may fall further into the USD20 to USD30 dollar per barrel range. This will place significant cost pressures on all oil and gas projects globally, but particularly within Australia given the enormous development and high ongoing operating costs.

The fall in the oil price, when coupled with significant cost overruns in the many billions of dollars in developing these projects and lengthy delays to commencement of production are causing significant concerns with regards the IRR and NPV's of these projects.

In terms of the LNG precincts developed around Australia, we note most of these facilities are capable of expansion. This includes the Ichthys processing facilities in Darwin where the site has capacity for an additional four LNG processing trains, which would require significant further investment, but would generate significant employment and economic benefits to Australia. Expansion decisions will be made on an incremental basis, i.e. what incremental NPV do any of the options for expansion bring to the Ichthys LNG Project and its associated facilities. As LNG trains are capital intensive, changes to the taxation regime, particularly with regard to the deductions for capital expenditures, could render expansion uneconomic.

If expansions do not occur, then there is the potential that a number of LNG precincts across Australia could be under-utilised and the economic synergies that may arise having tie-in projects from smaller gas fields that could not be developed in their own right may be lost. This would likely end up being an economic loss to the broader Australian economy given it is unlikely that smaller enterprises could generate enough economic activity to replace that generated by an expansion project on an LNG facility.

It would also be contrary to the consolidation within LNG precincts which the former Federal Resources Minister, the Honourable Martin Ferguson AM expressed publically as the then Federal Government's preferred development model for gas-fields.

INPEX

3. UNIFORM CAPITAL ALLOWANCES

The oil and gas industry by its very nature is capital intensive and the Ichthys LNG Project alone represents a capital investment of more than USD 34 billion. INPEX has provided comments on two particular areas of the UCA provisions that are of importance to a capital intensive project.

Statutory Capped Lives

The broadening measures regarding depreciation, in particular the statutory capped lives for oil and gas assets are, in INPEX's opinion, the area which is most detrimental to future investment.

The caps, which were introduced in 2002, were designed to help companies commit to capital intensive, long life projects within Australia. A statutory cap enables taxpayers to bring forward tax deductions to an earlier income year than if a longer life applied. This results in a slight deferment in the payment of income tax that can significantly improve the economics of long term investments. That is, the IRR/NPV can be improved enabling a company to potentially make a favourable FID to move projects forward.

Whilst an amendment to the statutory capped lives does not change the total deduction or ultimately the tax payable it significantly brings forward the timing of tax payments. From an investment perspective, bringing forward the timing of tax payments is significantly detrimental to the IRR/NPV. Extrapolating this result to a future investment decision, this detrimental impact on the IRR/NPV by removing the statutory capped lives may be significant in the context of a project/expansion.

It is important to note that the statutory cap only commences to be of benefit to a project once the assets are "ready for use". Unfortunately for most LNG projects with a five – seven year construction period prior to an asset being ready for use, the effective life of oil and gas assets can be between 22 and 27 years before the asset cost is deducted in full from when the spend may have been incurred. It is furthermore important to note that in an international context the capped lives for oil and gas assets are not concessional and that many other large oil and gas producing countries enable significantly shorter write off periods.

Diminishing Value rate cut to 150%

With regards to any potential to change the diminishing value rate to 150%, INPEX notes that the reason why the existing [200%] rate was introduced in the first place was to better align depreciation deductions with the actual rate at which assets decline in value. When the BTWG floated this reduction as a potential source to fund a corporate tax rate cut, they suggested that re-visiting this measure may have been considered appropriate on the basis that it is "difficult to accurately measure economic depreciation."

INPEX believes the original policy intent behind the change is still appropriate and notes that, much the same as with the statutory caps, the slight deferment in the payment of income tax can improve the economics of a long term investment. This in turn may help favourable investment decisions.

As with the statutory cap comments above, extrapolating this result to a future investment decision, this detrimental impact to the IRR/NPV by reducing the diminishing value rate may be significant in the context of a project/expansion.

Other Depreciation Considerations

We note that APPEA in their submission has provided information on the competitiveness of the taxation regime for capital assets and refer the Committee to the APPEA submission for more detail.

We also note that changes to depreciation lives can have an adverse impact on operational costs for projects. This is on the basis that investors in assets such as aeroplanes, helicopters, etc. will, like oil and gas producers, require an investment hurdle to be met. The only real measure they have to achieve this return is to either adjust price or costs. Given the high cost environment within Australia, it is unlikely that costs could be adjusted, with the result that price increases will end up being absorbed by other sectors of the economy, such as the oil and gas sector.

A similar issue would exist for small oil and gas companies who rely on tolling to get their gas to markets. Changes to depreciation rates may mean oil and gas infrastructure owners need to increase the tolling charges to smaller oil and gas companies to ensure that they make an appropriate return on their infrastructure investments. This may render smaller "tie-in" gas fields no longer viable due to increased operating costs.

It is INPEX's position that given the impact on capital intensive industries, particularly oil and gas, any changes in the tax treatment of capital assets must be very carefully considered as deterioration to IRRs and the breakeven tax rate differential presents a very real risk of adversely impacting investment decisions in Australia.

INPEX

4. INTEREST

It is public knowledge that the proponents of the Ichthys LNG Project secured the largest syndicated project financing ever undertaken which provided the project sponsors the confidence to take the Ichthys LNG project into development.

As context, at the time INPEX took FID on Ichthys LNG it was ranked in the top one hundred global list of oil and gas companies and had a market capitalisation of approximately USD 20 billion. The FID decision meant INPEX was committed to its then share of 70% of the US 34 billion development budget, i.e. US 23.8 billion.

Given the sheer scale of the Ichthys LNG Project, INPEX simply could not fund this project through free cash flow or equity. External debt was essential and accordingly a project team was established to secure sufficient funds to ensure development could occur.

The Ichthys LNG project financing involves a number of Government export credit agencies and a syndicate of banks. The project sponsors (of which INPEX is one of eight) are required to also contribute a mix of debt and equity in agreed proportions with the lenders in the project financing. A significant number of debt covenants and financial ratios are then also required to be complied with and security is required to be provided over project assets.

This agreement between the lenders and project sponsors ensures the lenders have sufficient security to enable them to lend at all.

Future investments for INPEX will ultimately be financed by a combination of share capital, external debt and free cash flows. Given the large sums of capital required, usually in the USD billions, project financing may be required as the debt amounts are typically too large for one lender to manage on their own.

When undertaking a project financing, the lenders require the borrower to manage cash flow by using a cash waterfall. Cash outflows are limited to ensure the availability of cash to repay the debt and interest. One of the issues with changes that impact capital assets whose construction has to be underpinned by debt is that the project will be required to pay more tax earlier in the lifecycle (even when offset by a tax rate cut), which often coincides with the lending period. As tax represents cash that must be paid out, and be paid prior to the repayment of debt under a cash waterfall, the lending institutions factor this reduced level of cash into their debt capacity workings for the project. Accordingly, changes to tax laws in projects involving capital intensive oil and gas assets can affect the ability to borrow externally.

From a policy perspective the Government may feel comfortable with forcing entities to look at larger equity contributions to projects if the lending institutions simply refuse to lend as much as they previously would have. However, this policy objective can have unintended consequences as there will be a decline in shareholder returns.

In the oil and gas sector the majority of investment decisions made recently (and which are underpinning Australia's investment pipeline) are by foreign companies with inbound investment into Australia. This includes INPEX. Equity is, in general much more expensive than debt irrespective of the tax deductibility. Should these foreign entities be required to contribute more equity, a company can use free cash flow generated from other projects to put in further equity into a development project. Where a Weighted Average Cost of Capital (**WACC**) is utilised to determine the hurdle rate for IRR/NPV calculation purposes when assessing a project, the larger equity contribution will impact the WACC and therefore push the hurdle rate upwards. This means a project is at a disadvantage clearing the hurdle rate necessary to be granted FID. Utilising free cash for investment purposes is also likely to lead to negative reactions on the stock market, as investors, given the state of various economies around the world, are demanding that surplus cash to operating requirements be returned to them through either special dividends or capital reduction strategies.

In the event that a company does not have sufficient free cash flow to put in further equity into a project then the next alternative is a capital raising. For projects that have a short to medium term debt requirement but good cash prospects in the long run, investors are likely to respond negatively to any capital raising undertaken and it is likely to be dilutive on a per share basis. This is because equity ties cash up for investors invariably for too long a period of time and does not give them flexibility nor any guarantee of returns.

As a general comment, external lenders look closely at the deductibility of any interest paid due to the fact that any denied interest increases the income tax payments which therefore affects the cash waterfall. When the discussion first emerged on changing the thin capitalisation safe harbour debt amount from 75% to 60% debt-to-assets, significant analysis and re-modelling was undertaken by the lenders due to their concerns around the impacts on the cash waterfall, which also prompted a raft of questions to the sponsors with regards the impact this amendment has.

Should the Committee be looking at more significant changes to the deductibility of interest then it is important that they obtain an understanding about what could happen to the ability to borrow externally for capital intensive projects. It is also necessary to remember that during construction of major capital projects losses are generated, including from interest expense incurred on loans. The tax losses, if not able to be offset against current earnings from other projects, are carried forward and form an early shield enabling cash to be generated and flow through the cash waterfall to the debt repayments without any payments of income tax until all the tax losses are recouped.

Where a change arises that would deny interest but reduce the corporate tax rate, the amount of carry forward tax losses in the early stage of a project's production phase would reduce and potentially expose an entity to income tax significantly earlier than otherwise, albeit at a lower rate. The earlier payment of income tax will be value detrimental to the IRR/NPV of the project. Furthermore the physical payment of tax earlier in the production phase also results in an earlier impact upon the cash waterfall. Both of these parameters can have lending implications.

Accordingly the Committee should ensure it fully appreciates the commercial realities of funding large scale infrastructure and that a straight reduction in the corporate tax rate as a trade off to the deductibility of interest (be it via changes to the thin capitalisation regime or straight denial of deductibility) may actually not work out to be beneficial and encourage, or even enable investment decisions to be made.