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The Secretary
Senate Standing Committees on Economics
PO Box 6100
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Dear Secretary

Committee Inquiry: *Treasury Laws Amendment (2019 Petroleum Resource Rent Tax Reforms No. 1) Bill 2019*

The Australian Petroleum Production & Exploration Association (APPEA) is the national body that represents companies engaged in oil and gas exploration and production operations in Australia. APPEA's members account for the vast majority of Australia's oil and gas production and petroleum exploration. APPEA also represents a range of companies that provide goods and services to petroleum explorers and producers.

The oil and gas industry is an integral part of the Australian economy. Benefits include the supply of energy to the community and businesses, the investment of hundreds of billions of dollars of capital, the payment of taxes and resource charges to governments, the employment of tens of thousands of Australians and the generation of export earnings.

The industry is ending a decade of unprecedented capital investment. There is the potential to capture more opportunities in growing global and domestic gas markets. The next phase of investments, including extensions to existing projects, will be dependent on the resource taxation system.

In the context of the inquiry, APPEA recommends:

- The Committee supports the immediate passage of the legislation, including the removal of PRRT from onshore operations, with the new provisions to apply from 1 July 2019.
- The Committee acknowledges the negative impact on taxpayers of removing the option to transfer undeducted onshore exploration expenditure incurred between 1 July 2012 and 30 June 2019 following the date of effect of the amending legislation (1 July 2019), and supports the introduction of a limited transfer window of up to five years, with no further augmentation, to apply from 30 June 2019.

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Background

Operation of the Petroleum Resource Rent Tax

The petroleum resource rent tax (PRRT) has been an important part of the overall policy framework that has allowed the industry to both find and unlock Australia's oil and gas resources. The design of the tax recognises the need for companies to achieve a return on invested funds before the imposition of a resource tax liability. It has allowed Australia to become a world leader in the production of natural gas, despite our relatively small overall share of global natural gas resources.

The tax has operated in Australia since the mid 1980's. It first applied to new offshore projects in Australia, it was then extended to cover the Bass Strait project in 1990 and was finally extended in 2012 to cover all Australian petroleum operations. Critics of the tax have expressed concerns about its perceived under collection of revenue. These views do not recognise the global competition for capital, the risks borne by investors, the costs of exploring for and developing oil and gas resources in Australia and the relatively modest returns that many petroleum projects generate. More fundamentally, critics conveniently disregard the intentional design features of the PRRT, rather preferring to promote cash flow taxes that will simply discourage future investment in the sector.

In terms of its design, the PRRT is essentially a super profits tax used by the Commonwealth Government to tax economic rent from oil and gas projects in Australia. It is levied under the provisions of the Petroleum Resource Rent Tax Assessment Act 1987 (*the PRRT Act*).

A liability to pay PRRT arises when a project has recovered all eligible outlays associated with the project (including deducting eligible exploration expenditure transferred from other projects), with an allowance for a threshold rate of return. It includes the following basic features:

- It is assessed on an individual project basis. A project may comprise of one or more petroleum production licences.
- Liability to pay PRRT is on an individual producer/company basis (rather than a joint venture).
- As a 'resource' tax, it does not seek to tax downstream processing or liquefaction activities.
- It is assessed at a rate of 40 per cent.
- A tax liability arises when all allowable costs have been deducted from assessable receipts.
- Assessable receipts include amounts received from the sale of all petroleum.
- Deductions include capital and operating costs that relate to the petroleum project. Costs are deductible in the year they are incurred. Deductible expenditures include those related to exploration, development, operating and closing down activities.
- Undeducted expenditures are compounded forward at set rates depending on the nature of those expenditures and the time they are incurred.
- Other resource taxes and charges incurred in relation to a project are rebateable against a PRRT liability from a project to avoid the imposition of double taxation.
- Non-deductible costs include financing costs, some indirect administration costs, income tax and cash bid payments.
- PRRT tax payments are deductible against income tax.

In terms of structure, PRRT differs from company tax in a number of ways. Unlike company tax, where many costs are deductible over defined lives, all eligible deductions for PRRT purposes are immediately and fully expensed at the time they are incurred. Only eligible exploration expenditures are transferrable between projects owned by an individual taxpayer; project financing costs are not deductible.

The key metrics of PRRT remain broadly the same today as when they were first introduced in the mid 1980's. Overall, the tax represents an integrated package of measures ensuring the risks associated with undertaking exploration and development activities in Australia are balanced against the returns necessary to underpin high cost funding commitments.

Factors Impacting on the Payment of PRRT

A range of factors determine when and the amount of PRRT payable by individual licence holders, including the following:

- PRRT is payable after a threshold return has been generated for a company's share in a project. This will generally not be until a number of years after the commencement of production.
- A PRRT liability for a project may be deferred where eligible exploration expenditure incurred in another project held by the same taxpayer is transferable.
- Other resource taxes and charges from a project (such as state and federal royalties and production excise) are rebatable against a PRRT liability incurred in the same project. As indicated above, this avoids the imposition double resource taxation from the same project.
- As PRRT is a 'profits' based taxed, a tax liability will be dependent on a range of factors, such as oil and gas prices, exchange rates, levels of production and project costs.

Impact of the Extending PRRT Onshore

Following the decision of the Government in July 2010 not to proceed with the resource super profits tax, amending legislation was introduced into Parliament in late 2011 to extend the PRRT to cover all petroleum exploration and production activities in Australia, with effect from 1 July 2012.

The legislation was developed following a period of extended consultations. The extension required complex amending legislation and transitional provisions. Changes that accompanied the decision included the following:

- The provision of a 'starting-base' for projects and licences entering the regime to recognise past investments and expenditures to prevent the retrospective application of PRRT.
- Modifications to the project combination provisions to allow onshore projects integrated with downstream operations to be treated as single projects.
- Clarification was provided that environmental expenditures would be deductible.
- The scope of allowable deductions was expanded to include other resource taxes.

During the consultations in 2011 and 2012, it was acknowledged that there was little likelihood of onshore projects ever paying PRRT. Notwithstanding this, all companies (including many small and mid-sized entities typical in the Australian onshore industry) were required to implement new accounting systems and must comply with the various reporting and administrative obligations. That was in addition to complying with the royalty and excise laws already in place.

In addition, a number of operational and licencing features associated with onshore operations were not considered when the regime was first introduced for the offshore industry in the mid-1980s. As a result, uncertainty surrounding some aspects of the PRRT as it applies to the onshore industry remain as of 2019.

Recent Reviews of the Operation of PRRT

The Callaghan Review

In November 2016, the Government announced an independent review into petroleum resource taxes in Australia - the main focus was PRRT. The review was led by former senior Treasury official, Mr Michael Callaghan AM PSM, with the support of a secretariat comprising officers from Treasury, the Australian Taxation Office and the Department of Industry, Innovation and Science.

An issues paper was released in late December 2016 providing background on the PRRT, excise and Commonwealth royalty arrangements, along with public comments made by external stakeholders regarding the design and operation of the various taxation provisions. Submissions were invited and the review team conducted extensive consultations covering all interested stakeholder groups.

The review's report was released by the Government in April 2017. It confirmed the findings of previous reviews that the PRRT achieves "a fair return to the community for the extraction of petroleum resources without discouraging investment". The review stressed:

> *'In considering the extent and timing of any changes to the PRRT, however, allowance has to be made for the very large recent investment in the Australian petroleum sector on the basis of long-standing taxation arrangements. The overall stability of the PRRT has contributed to this large investment. Given the range of uncertainties involved in large, long-term petroleum investments, stability in fiscal settings is an important factor influencing a country's investment attractiveness. Moreover any substantial change to the PRRT should be the outcome of a considered, comprehensive and consultative process.'*

The report made a series of recommendations, some of which applied to new projects, with others covering both new and existing projects. The recommendations addressed aspects of the augmentation, transferability, gas transfer price and technical operation of the legislation. A copy of the recommendations is at Attachment 1.

Treasury Review

Upon the release of the findings of the Callaghan report, the Federal Treasurer announced that further work would be undertaken by Treasury to assist the Government in making any final decisions. It was stated any changes should take into account the need to ensure that the PRRT provides an equitable return to the Australian community from the recovery of petroleum resources without discouraging investment in exploration and development.

Treasury released a public discussion paper in June 2017 canvassing the possible reforms to PRRT identified as part of the Callaghan review. Treasury sought submissions and undertook targeted consultations with stakeholders. As part of the consultation process, APPEA identified concerns about retrospective changes and negative impacts on future exploration and development decisions.

Senate 'Corporate Tax Avoidance' Inquiry

As part of its ongoing inquiry into corporate taxation, the Senate Economics References Committee in early 2017 invited submissions into the treatment and payment of oil and gas taxes in Australia. Hearings were held that covered the operation of PRRT.

A final report from the Committee was released in May 2018. It noted key aspects of the operation PRRT and made a number of observations, including the following:

> *"5.137: The committee endorses the direction of the Callaghan Review's recommendations. In particular, it concludes that:*
> - *uplift rates should be lowered*
> - *the ordering of deductions should be rationalised and*
> - *the residual pricing method should be scrutinised.*
>
> *5.138: The committee agrees with the conclusions of the Callaghan Review, that changes are necessary but that, in order to maintain certainty for the sector, they should apply only to future projects.*
>
> *5.139: The committee notes that the ATO already maintains close contact with companies in the PRRT system. It believes that consideration should be given to establishing a specific body, possibly within the ATO, to monitor administration of the PRRT, and to ensure that the self-assessment processes work appropriately. Whatever arrangements are in place, it is essential that they be adequately resourced.*
>
> *5.140: The committee notes the arguments for a royalty on all projects. It sees a good deal of merit in them, but believes that a properly functioning PRRT, in conjunction with the base erosion and profit-shifting measures discussed elsewhere in this report, would meet the objectives of ensuring the oil and gas companies appropriately contribute to government revenue. "*

In addition, the Senate Committee made a number of formal recommendations in terms of the Callaghan report and possible changes to the PRRT settings.

- The government finalise and release its response to the Callaghan report. (*Recommendation 10*)
- The government overhaul uplift rates for future PRRT eligible projects, so as to make them less generous. (*Recommendation 11*)
- The ordering of deductions be rationalised for future PRRT eligible projects so that those with the highest compounding rates are used first for tax deduction purposes. (*Recommendation 12*)
- The gas transfer pricing method for PRRT eligible projects be reformed to make it simpler and more transparent so as to ensure that it delivers a fair return to the community. (*Recommendation 13*)

<u>Final Government Position on PRRT and Treasury Laws Amendment (2019 Petroleum Resource Rent Tax Reforms No.1) Bill 2019</u>

Announced Changes

The Government announced its formal response to the Callaghan review on 2 November 2018, noting the importance of providing certainty for industry and the need to ensure the PRRT reflects the nature of the petroleum industry in Australia today. Changes announced to apply from 1 July 2019 included the following:

- **Lower uplift rates**: These changes will limit the scope for excessive compounding of deductions. For example, the uplift rate on exploration expenditure will be reduced from Long Term Bond Rate (LTBR) + 15 percentage points to LTBR + 5. Existing investments will be respected.
- **Onshore projects removed from the PRRT regime**: Since onshore projects were brought into the PRRT in 2012, no revenue has been collected and that was expected to remain unchanged into the future. In practice, it has been used to transfer exploration deductions to profitable offshore projects reducing PRRT payable. This change will simplify the system and strengthen its integrity.
- **Review of Gas Transfer Pricing Regulations**: Treasury will commence a review into the regulations that determine the price of gas in integrated LNG projects for PRRT purposes. Treasury will consult closely with the industry and community.

The announced changes are forecast to raise an additional $6 billion in revenue over the next decade.

Exposure draft legislation was released for public comment in late 2018, with amending legislation introduced into the House of Representatives on 13 February 2019. The amendments contained in <u>Treasury Laws Amendment (2019 Petroleum Resource Rent Tax Reforms No. 1) Bill 2019</u> cover two elements of the announced changes, together with a number of related transitional provisions. The key changes contained in the Bill are:

- lowering the uplift rates that apply to certain categories of carried forward expenditure; and

- removing onshore petroleum projects from the scope of the PRRT.

A second tranche of amendments will be introduced later in 2019 and will include the following changes announced in the Government's earlier response:

- improved rules to identify petroleum projects to ensure the true scope of each project is recognised;
- more corporate groups will be able to access the benefits of grouping, including group lodgement obligations and broader access to functional currency rules;
- greater certainty will be created for deductible expenditure arising before a petroleum project starts to derive assessable receipts through taxpayers being required to lodge annual PRRT returns (and receive assessments) after they start holding an interest in a permit, lease or licence;
- taxpayers will be able to use a substituted accounting period for PRRT purposes if they have adopted the period for income tax purposes;
- a new power for the Commissioner of Taxation to administratively exempt projects from PRRT obligations where they are clearly unlikely to pay PRRT in the foreseeable future until they start production or PRRT becomes payable; and
- the PRRT general anti-avoidance provisions will be strengthened to reflect changes made to Part IVA of the Income Tax Assessment Act 1936.

The announced Treasury review into the operation of gas transfer price regulations will report back to Government within 12 to 18 months from the original November 2018 announcement.

Industry Position

Industry and successive federal governments have long recognised the benefits of the PRRT regime. While minor changes have been made since the tax was introduced in the mid 1980's, the overall settings have remained largely unchanged.

The Callaghan review represented the most comprehensive examination of the tax. The recommendations of the review, and the Government's subsequent response in late 2018, broadly supported the conclusion that the tax represents the best resource taxation model for offshore petroleum operations in Australia.

APPEA supported the decision of the Government to initiate a facts based review of PRRT and welcomed the conclusion that the tax remains appropriate for Australia. Notwithstanding this support, there are some concerns with aspects of the announced changes, as they either do not fully recognise past investments and/or may lead to future complexity.

- Exploration carry-forward rates

The proposed reduction in the augmentation (carry forward) rate for exploration expenditure from LTBR plus 15 percentage points to LBTR plus five points will in some instances lead to an increase in the after tax cost of undertaking exploration. Australia has experienced a long term decline in exploration over the last decade, with exploration languishing at historically low levels

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of activity – this is particularly the case offshore. Ongoing petroleum exploration is essential to support the east coast domestic gas market.

While it is understood that other aspects of the exploration provisions have been retained (such as the transferability of offshore expenditures to other projects held by a taxpayer), the future reduction in the value of exploration deductions for PRRT purposes is arguably not consistent with the desire to increase exploration in Australia.

- Transferability of onshore exploration costs

The decision to remove the onshore industry from the scope of the tax from 1 July 2019 means onshore petroleum exploration expenditure incurred by taxpayers in the period 1 July 2012 to 30 June 2019 will no longer be transferable to offshore project interests held by the same taxpayer (for years after 2018-19). While it is acknowledged that this should be the case for onshore exploration expenditure incurred after 30 June 2019, the legislation disadvantages companies who have invested in onshore exploration in the period where PRRT applied onshore. This is because there are instances were taxpayers have been unable to transfer part or all of the onshore exploration expenditure to PRRT paying offshore projects before 1 July 2019 (when the new provisions will commence). Had some investors been aware this change would occur, exploration funds may have been directed to offshore instead of onshore areas. A significant proportion of onshore exploration in this period occurred in areas other than those onshore projects that were brought into the PRRT on 1 July 2012.

The cost of this change will fall most heavily on companies that have been exploring onshore for natural gas, particularly to support the east coast domestic gas market. Wider deductibility of exploration has been an integral design feature of the tax since 1991. While general project expenditures effectively 'expire' when a project ceases to exist (through not being transferable), exploration deductions have traditionally been retained and can be utilised into the future, subject to the normal integrity and transferability rules.

While the decision to remove onshore projects from the scope of the regime recognizes that PRRT is unlikely to be payable by the onshore projects brought into the PRRT on 1 July 2012, the decision to effectively 'dissolve' undeducted onshore exploration expenditures incurred by companies in the period 2012 to 2019 represents the removal of an entitlement to legitimate deductions incurred by taxpayers during this period. APPEA considers this represents poor tax policy and is inconsistent with the tax treatment of offshore exploration expenditures over the same period that will appropriately remain transferable to PRRT paying projects held by a taxpayer.

In the context of the above, APPEA recommends that the Committee acknowledges this design flaw and considers an amendment to allow for the transferability of onshore exploration expenditures incurred by a taxpayer between 1 July 2012 to 30 June 2019 for the limited period of time post the introduction of the new law, with no further augmentation.

- Creation of 'old' and 'new' offshore production projects

The decision to effectively create 'new' and 'old' projects with different carry forward rates reflects the view that past investments should not be subject to retrospective tax changes. A consequence of this decision is that complexities can arise when 'new' and 'old' projects are combined for PRRT purposes.

By way of example, the proposed new law requires 'old' projects must become 'new' projects when they are combined with a 'new' production licence. It is common across the industry to have investment decisions made and infrastructure built with the intention to develop a variety of production licenses and retention leases held by a taxpayer to provide the critical mass to justify large scale capital investments. Taxpayers who in the past may have elected to combine projects for PRRT purposes may now choose to do otherwise due to the less attractive provisions that apply to 'new' investments.

<u>Recommendations</u>

A number of important prospective investment decisions are presently confronting companies in the industry. These decisions cover both new petroleum projects and extending the lives of existing projects. A range of decisions also need to be undertaken in terms of future exploration commitments.

While the announced changes to the regime will both increase and bring forward the payment of PRRT by taxpayers in the industry, APPEA considers the certainty necessary to underpin future investments in the industry is best achieved through the Committee supporting the immediate passage of the legislation, with a 1 July 2019 start date.

APPEA also recommends the Committee acknowledges a design flaw in the onshore transferability provisions and supports an amendment to allow for the transferability of onshore exploration expenditures incurred by taxpayers to offshore PRRT payment projects held by the same taxpayer for a limited period of time post the date of effect of the new provisions, with no further augmentation.

Contact in APPEA is Noel Mullen [redacted]

Yours sincerely

Malcolm Roberts
Chief Executive

Attachment 1

Petroleum Resource Rent Tax Review Final Report – April 2017

Part A. Recommended changes to apply to new PRRT projects

Recommendation 1. A process should be established, involving full consultation with industry and the community, to update the PRRT arrangements so that they are more appropriate to the current Australian oil and gas industry. This process should be comprehensive and take into account the integrated nature of the PRRT along with likely future developments in the Australian petroleum industry. Changes to the PRRT from this process should only apply to new projects (as defined in the PRRT legislation) after a date to be specified. Areas that should be considered include:

- Changing the arrangement for the uplift rates for all deductible expenditures such that they are more commensurate with the risk of losing PRRT deductions, taking into account transferability and that this risk will vary over the life of a project;
- Ensuring that classes of expenditure with the highest uplifts are deducted first having regard to how deductions can compound in large, long-life projects;
- Examining the rules for the transferability of deductions between projects in a company to ensure they produce a consistent set of outcomes; and
- Examining the gas transfer pricing arrangements to identify possible changes that would achieve greater simplicity and transparency, ease of compliance, and fair treatment of the economic rent from each stage of an integrated petroleum operation. In particular, issues to consider include:
  - Strengthening the scope to use a CUP as the primary method of setting the gas transfer price in line with international best practice and recent work by the Organisation for Economic Co-operation and Development (OECD); and
  - Where a CUP is not available, examining the appropriateness of the asymmetric treatment of upstream and downstream operations, the way profits are split between upstream and downstream, and the rate of the capital allowance in the RPM.

Part B. Recommended changes to apply to existing and new PRRT projects

Recommendation 2. When the PRRT was extended to onshore projects and the NWS project in 2012, to facilitate the transition of these projects they were provided with an additional amount of deductible expenditure called a starting base. The integrity measure introduced at that time which excluded transitioning projects with a starting base from combining with offshore projects should be extended to include a prohibition between transitioning projects with a starting base combining with future onshore projects without a starting base. This will avoid the revenue risk posed by transitioning projects with a starting base combining with other projects without a starting base to form a single PRRT project that would use the starting base amount as a tax shield for the whole project.

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Recommendation 3. Under the PRRT, closing down expenditure is a recognised category of deduction, which may be refunded to the limit of past PRRT payments. The implications for PRRT revenue should be taken into account in the current review of the policy and legislative framework for the decommissioning of projects in Commonwealth waters being undertaken by the Department of Industry, Innovation and Science. Any changes to decommissioning requirements coming from this review should take into account that onerous closing down requirements will significantly affect PRRT revenue.

Recommendation 4. The PRRT has a linear, or cradle-to-the grave, treatment of the phases involved in a petroleum project's operational life and this no longer captures the characteristics of multi-stage projects that have become a common feature of the industry. Projects are now designed to operate for upwards of 40 years, although parts of the project will be closed over that time. The ATO is currently undertaking consultations to clarify the treatment of closing down expenditure within the meaning of the legislation. If this review does not provide sufficient clarity to deal with partial closing down situations, the legislation should be amended to recognise partial closing down expenditure as a legitimate general project expense. There is no reason why expenditure that is deductible when a project is completely closing down should not be deductible because the project is partially closing down.

Recommendation 5. Under current PRRT arrangements, a PRRT taxpayer is only required to lodge an annual return with the ATO when a project starts producing assessable receipts. It is only at this point that a PRRT taxpayer is required to disclose the carried forward deductible expenditure for the project to the ATO. Given the long lead times for some projects, this expenditure may have occurred many years prior to a return being lodged, which can result in considerable uncertainty for PRRT taxpayers and significantly restricts the ATO's ability to undertake compliance activity. This also affects the ATO's ability to provide reliable data to Treasury for revenue forecasting purposes. To deal with this, the PRRT arrangements should be amended such that PRRT taxpayers are required to lodge annual returns after they start holding an interest in an exploration permit, retention lease or production licence rather than having to wait until they receive assessable receipts from the project.

Recommendation 6. The PRRT design feature which links a project to a production licence does not align with current commercial practice whereby a production licence may revert to a retention lease. The Commissioner of Taxation should be given the power to treat a new project as a continuation of an earlier project, where it would be reasonable to do so.

Recommendation 7. The structure of ownership interests used by the industry is becoming more diverse and fragmented and less likely to remain constant through the life of a project. To deal with these increasingly complex structures that were not envisaged when the PRRT was introduced, the Commissioner of Taxation should be given the discretion to recognise more than one project from a production licence area for genuinely separate and independent petroleum operations in the licence area.

Recommendation 8. Entities within a wholly owned group currently have the option to have all the interests held by the group in an onshore project taken together and reported as a single PRRT return (without affecting the project-based nature of the tax). This compliance cost saving measure should be extended to offshore projects.

Recommendation 9. Currently all PRRT tax payers must prepare their PRRT return on a 30 June year end, which is out of step with income tax and accounting rules. The PRRT arrangements should be amended such that PRRT taxpayers can chose to adopt a substituted accounting period for PRRT so it can align with their choice to use a substituted accounting period for income tax.

Recommendation 10. The functional currency rules for PRRT are out of step with those for income tax as they do not recognise a functional currency choice by a 'Multiple Entry Consolidated (MEC) group'. A MEC group is an income tax consolidated group of Australian entities that are wholly foreign-owned and do not have a common Australian head company. The PRRT arrangements should be amended so that PRRT taxpayers operating with a MEC group can make a functional currency choice for PRRT purposes that aligns with the functional currency choice made for income tax purposes.

Recommendation 11. Given that some PRRT projects are unlikely to ever pay PRRT (such as the oil project on Barrow Island), in order to reduce compliance costs for taxpayers and administrative costs for the ATO, the Commissioner of Taxation should be given the power to administratively exempt projects from lodging PRRT returns where they are clearly unlikely to pay PRRT in the foreseeable future.

Recommendation 12. Amendments were made to the income tax anti-avoidance rules in 2013 to ensure they operated as intended after a number of Federal court cases suggested there were deficiencies in identifying a 'tax benefit'. The PRRT anti-avoidance rules should be amended in line with the amendments to the income tax rules.