

# Chapter 6

## Extension of the Petroleum Resource Rent Tax

6.1 The Petroleum Resource Rent Tax (PRRT) applies to the profits derived from the extraction and early processing of petroleum within a petroleum project. It is levied at 40 per cent of a project's taxable profit and currently applies to projects in Commonwealth waters with some exceptions.<sup>1</sup>

6.2 As part of the Minerals Resource Rent Tax (MRRT) package, the government intends to expand the coverage of the PRRT so that from 1 July 2012 it applies to all onshore and offshore oil and gas production in Australia.<sup>2</sup> Relevant Commonwealth and state excise and royalties will continue to apply, and both these and any MRRT payments will be deductible for the purposes of calculating a company's PRRT liability.

6.3 This chapter examines this component of the MRRT legislative package.

### The Petroleum Resource Rent Tax

6.4 The PRRT was introduced by the Hawke Government and applied from 1 July 1986.<sup>3</sup> The assessment of PRRT liabilities is on an individual petroleum project basis.<sup>4</sup> Activities which are beyond the extraction and early processing of a petroleum resource, such as refining, are known as 'downstream' activities and are not subject to PRRT.

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1 At present, the North West Shelf project (where Commonwealth crude oil excise and royalties apply) and the Joint Petroleum Development Area (a region in the Timor Sea jointly managed by the Governments of Australia and East Timor and governed by the *Timor Sea Treaty* (2003)) remain outside the PRRT. Department of Resources, Energy and Tourism, 'The History of Petroleum Resource Rent Tax (PRRT)' [www.ret.gov.au/resources/enhancing/taxation/prrt/Pages/TheHistoryofPetroleumResourceRentTax\(PRRT\).aspx](http://www.ret.gov.au/resources/enhancing/taxation/prrt/Pages/TheHistoryofPetroleumResourceRentTax(PRRT).aspx), 17 January 2011 (accessed 9 November 2011).

2 Under the proposed arrangements, the Joint Petroleum Development Area in the Timor Sea will continue to be outside the PRRT regime.

3 The Bass Strait project came under the PRRT arrangements from 1 July 1990.

4 The Federal Court has observed that while the term 'project' and the boundaries of petroleum projects are not explicitly defined, they are informed by other sections and linked to production licences by section 19 of the *Petroleum Resource Rent Tax Assessment Act 1987* (PRRTA Act). A licence area does not constitute the entirety of a petroleum project—a project can include activities which are related to the project but which take place outside the licence area *Esso Australia Resources Pty Ltd v Federal Commissioner of Taxation* (2011) 194 FCR 32, 79, 80 (Middleton J); Petroleum Resource Rent Tax Assessment Amendment Bill 2011 and related bills, *Explanatory Memorandum*, p. 9.

6.5 A person who earns a taxable profit in relation to a petroleum project is liable to pay the PRRT. The taxable profit is calculated with reference to the assessable receipts related to the project after eligible project and exploration expenses are deducted. Assessable petroleum receipts, and therefore the PRRT taxing point, result from:

- the sale of petroleum prior to a marketable petroleum commodity<sup>5</sup> being produced; and
- marketable petroleum commodities that become 'excluded' by being sold, further processed or treated after being produced, or by being moved from the place of production (i.e. the sale or value of a marketable petroleum commodity).

### ***Deductible expenditure***

6.6 In determining a PRRT liability, certain expenses upstream of the taxing point can be deducted. The *Petroleum Resource Rent Tax Assessment Act 1987* (PRRTA Act)<sup>6</sup> outlines eligible deductible expenditure for a project in some detail, but essentially payments of either a capital or revenue nature in relation to a petroleum project, provided they are not of a type expressly excluded by section 44 of the PRRTA Act,<sup>7</sup> may be deducted against assessable receipts if they relate to general project expenditure, exploration expenditure or closing-down expenditure in the circumstances provided for by the Act.

6.7 Any excess undeducted expenditure from a tax year is eligible to be compounded annually at set rates and deducted against assessable receipts in future years until it can be fully absorbed against assessable receipts from the project.<sup>8</sup> As the PRRT is project-based, any excess expenditure in a financial year is generally not transferrable to other projects. The exception is exploration expenditure which must be transferred, although this is subject to a number of conditions.

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5 A marketable petroleum commodity is currently defined as any one of five specified products (stabilised crude oil; sales gas; condensate; liquefied petroleum gas; and ethane), as well as any other product prescribed by regulations, which is produced from petroleum and is in its final form for the purpose of sale, use as a feedstock for conversion to another product or direct consumption as energy. The PRRT Bill seeks to amend this definition to add shale oil as a specified product.

6 *Petroleum Resource Rent Tax Assessment Act 1987*, Part V, Division 3.

7 Excluded expenditure includes, among other things, financing costs, dividend payments, certain indirect payments and costs and payments of income tax and GST.

8 Australian Taxation Office, 'Petroleum resource rent tax: overview', 17 August 2009, [www.ato.gov.au/businesses/content.aspx?doc=/content/39230.htm&pc=001/003/117/001/001&mnu=44895&mfp=001&st=&cy](http://www.ato.gov.au/businesses/content.aspx?doc=/content/39230.htm&pc=001/003/117/001/001&mnu=44895&mfp=001&st=&cy) (accessed 6 December 2011).

## Overview of the proposed extension

6.8 At present, the PRRT is imposed by and assessed under the following legislation:

- *Petroleum Resource Rent Tax Act 1987*; and
- PRRTA Act.

6.9 To give effect to the proposed extension of the PRRT, the package of bills introducing the MRRT includes four bills (collectively referred to as the PRRT Bills):

- Petroleum Resource Rent Tax Assessment Amendment Bill 2011 (PRRT Bill);
- Petroleum Resource Rent Tax (Imposition—General) Bill 2011; Petroleum Resource Rent Tax (Imposition—Customs) Bill 2011; and Petroleum Resource Rent Tax (Imposition—Excise) Bill 2011 (collectively referred to as the PRRT Imposition Bills).

### *Resources covered by the extended PRRT*

6.10 Most of Australia's conventional petroleum resources are located offshore in Commonwealth waters. Ninety-two per cent of Australia's conventional gas resources are located in the offshore basins which make up the North West Shelf.<sup>9</sup>

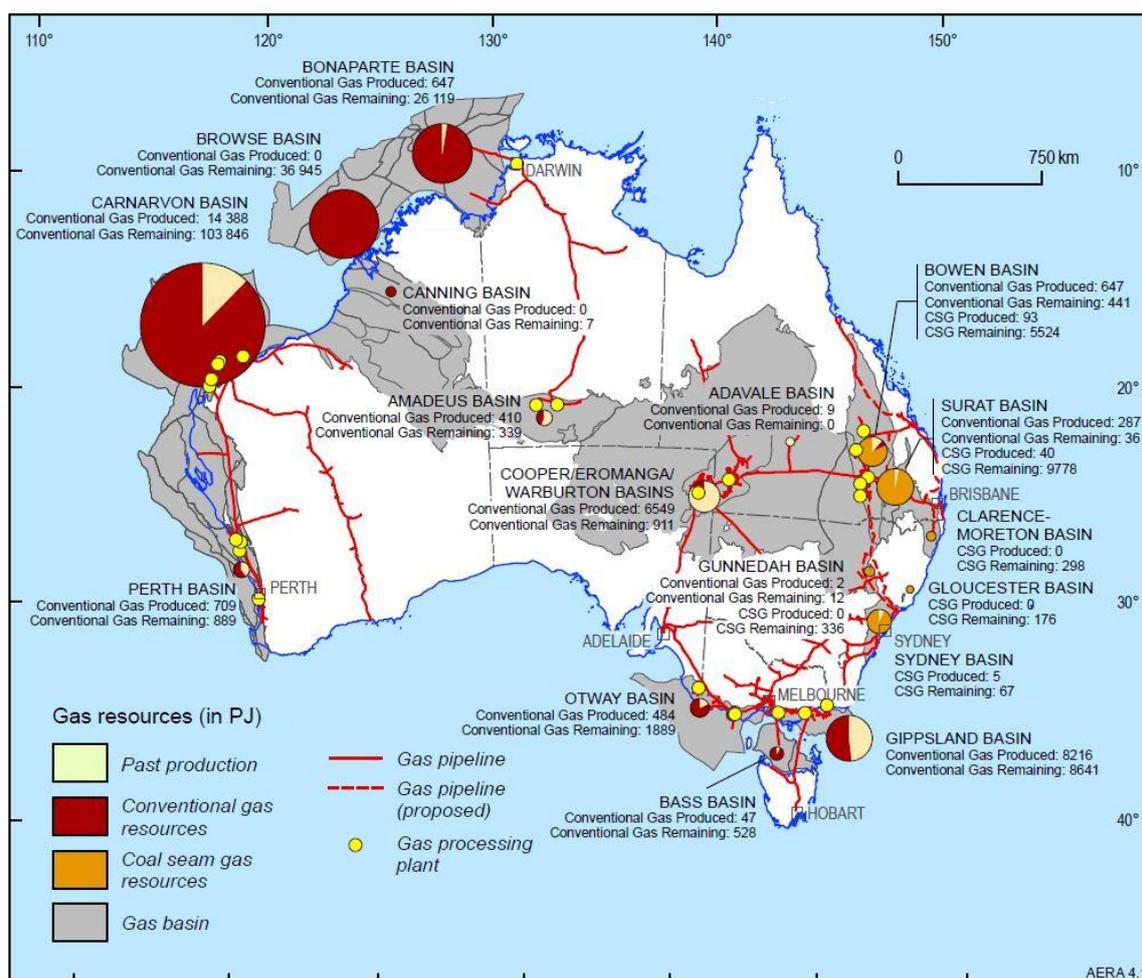
6.11 Two petroleum resources which the PRRT Bills seek to bring into the PRRT regime are coal seam gas and oil shale. Australia's proven and probable coal seam gas resources (37,896 petajoules (PJ) in August 2011) are largely located in southern Queensland (92 per cent of the total), with the remaining reserves found in areas of New South Wales.<sup>10</sup> Coal seam gas production has been increasing significantly, rising from around 17 PJ in 2008 to 231 PJ in 2010–11.<sup>11</sup> However, offshore projects still represent the bulk of conventional natural gas production; Figure 6.1 illustrates the scale of Australia's offshore conventional gas resources compared to the coal seam gas resources that are currently considered commercially viable.

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9 Geoscience Australia and ABARE, *Australian Energy Resource Assessment*, 2010, p. 95.

10 Australian Energy Regulator, *State of the Energy Market 2011*, December 2011, p. 79. Geoscience Australia and ABARE noted in 2008 that while coal seam gas accounted for about 12 per cent of Australia's gas resources that are classified as 'economically demonstrated', there are substantial subeconomic demonstrated resources and very large reserves classified as 'inferred' and 'in-ground potential' which may total over 150 000 PJ—many times larger than the current level of economic demonstrated coal seam gas resources. Geoscience Australia and ABARE, *Australian Energy Resource Assessment*, 2010, pp. 96–98.

11 Australian Energy Regulator, *State of the Energy Market 2009*, December 2009, p. 31; *State of the Energy Market 2011*, December 2011, p. 80.

**Figure 6.1: Location of Australia's gas resources and infrastructure**

Source: Geoscience Australia and ABARE, *Australian Energy Resource Assessment*, 2010, p. 84.

6.12 The addition of oil shale and shale oil (a product produced from oil shale) to the PRRT regime appears to be of limited consequence in the short-term; in 2010 it was reported that there was no oil being extracted from oil shale in Australia.<sup>12</sup> However, this could change in the future. Geoscience Australia considers:

Australia has a large unconventional and currently non-producing identified shale oil resource of 131 600PJ (22 390mmbbl) which could potentially contribute to future oil supply if economic and environmental challenges can be overcome.<sup>13</sup>

6.13 While coal seam gas and oil shale are being brought into the PRRT regime, the much larger scale of the North West Shelf project means its treatment appears to be the key to any short- or medium-term changes to Commonwealth revenue

12 Geoscience Australia and ABARE, *Australian Energy Resource Assessment*, 2010, p. 69.

13 Geoscience Australia, 'Oil Shale', 30 March 2011, [www.ga.gov.au/energy/petroleum-resources/oil-shale.html](http://www.ga.gov.au/energy/petroleum-resources/oil-shale.html) (accessed 5 December 2011).

associated with the PRRT extension. While coal seam gas production is increasing rapidly, current exploration trends suggest that the extraction of petroleum offshore will remain the focus of the Australian petroleum industry for some time. In 2010–11, offshore petroleum exploration expenditure totalled almost \$2.6 billion, compared to around \$760 million spent onshore.<sup>14</sup>

## Provisions of the Bills

### *Proposed changes to the structure of the PRRT legislation*

6.14 The PRRT Bills include some proposed amendments that are based on constitutional considerations. The PRRT Bill proposes to repeal the Petroleum Resource Rent Tax Act, which currently imposes the PRRT as a tax. This function will then be performed by the three PRRT Imposition Bills which will apply to the extent that the PRRT can be considered a duty of customs, a duty of excise and neither a duty of customs nor excise. The PRRT Imposition Bills will apply retrospectively from when the PRRT first commenced (1 July 1986), although this does not alter the operation of the PRRT.<sup>15</sup>

6.15 Under section 55 of the Constitution:

Laws imposing taxation shall deal only with the imposition of taxation, and any provision therein dealing with any other matter shall be of no effect.

Laws imposing taxation except laws imposing duties of customs or of excise, shall deal with one subject of taxation only; but laws imposing duties of customs shall deal with duties of customs only, and laws imposing duties of excise shall deal with duties of excise only.

6.16 The Explanatory Memorandum argues:

The constitutional validity of the PRRT is not in question. However, the three imposition Bills are being introduced to avoid the possibility of constitutional irregularities arising in the future ...

The approach of enacting a single assessment Bill with multiple imposition Bills when a tax law could be argued to be a duty of customs, a duty of excise, as well as some other type of tax is not unusual. The same approach was followed for the enactment of the goods and services tax (GST) legislation and the MRRT.<sup>16</sup>

6.17 Fulfilling a further requirement outlined in section 114 of the Constitution, the PRRT Imposition Bills each include a provision which expressly states that the

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14 Australian Bureau of Statistics, 'Mineral and Petroleum Exploration', cat. 8412.0, June 2011.

15 Petroleum Resource Rent Tax Assessment Amendment Bill 2011 and related bills, *Explanatory Memorandum*, p. 8.

16 Petroleum Resource Rent Tax Assessment Amendment Bill 2011 and related bills, *Explanatory Memorandum*, pp. 7–8.

respective bill does not impose a tax on property of any kind belonging to a state.<sup>17</sup> The utilisation of three imposition bills to impose the tax and the express recognition that the tax will not be imposed on property belonging to a state reflects the approach taken by the MRRT Bills.

### ***Arrangements for projects and industries transitioning to the PRRT***

6.18 The PRRT Bill seeks to make a number of amendments to the PRRTA Act to account for certain characteristics of onshore projects and the North West Shelf project. The more significant arrangements for these transitioning projects, and other key features of the expanded PRRT, are discussed below.

#### *Existing royalty and excise arrangements to continue*

6.19 The North West Shelf project and onshore petroleum projects are currently subject to state and Commonwealth royalties and excise.<sup>18</sup> Other offshore projects, such as the Bass Strait project, are not subject to the Commonwealth royalty/excise regime but are instead covered by the PRRT. These arrangements will not be changed under the extended PRRT. To avoid double-taxation, the extended PRRT will allow payments of Commonwealth, state and territory resource taxes (such as royalties and crude oil excise) in relation to a project to be grossed up and deducted against current and future assessable receipts.<sup>19</sup>

#### *Starting base amounts*

6.20 A transitional arrangement for projects shifting to the PRRT regime is an allowance for a starting base. This would allow holders of interests in transitioning petroleum projects, exploration permits and retention leases to choose and apply an additional deductible expenditure amount (a starting base amount) in determining their PRRT liability. Alternatively, the holders of these interests may take account of project expenditures incurred prior to 2 May 2010 in determining their PRRT liability. The Explanatory Memorandum states the starting base arrangements are 'in recognition of investment made prior to the Government's announcement' of the PRRT extension.<sup>20</sup>

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17 The Explanatory Memorandum notes that '[i]n practice, this will only have an effect to the extent that a State directly recovers its own petroleum resources. In that case, the State will not be subject to PRRT'. Petroleum Resource Rent Tax Assessment Amendment Bill 2011 and related bills, *Explanatory Memorandum*, p. 8.

18 The North West Shelf project is subject to Commonwealth crude oil excise under the *Excise Tariff Act 1921* and petroleum royalties under the *Petroleum (Offshore) Royalty Act 2006*.

19 Petroleum Resource Rent Tax Assessment Amendment Bill 2011, schedule 3, item 14.

20 Petroleum Resource Rent Tax Assessment Amendment Bill 2011 and related bills, *Explanatory Memorandum*, p. 67.

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### *Calculating a starting base*

6.21 A new category of deductible expenditure will be inserted into the PRRTA Act to provide for the deductibility of the starting base amount against assessable receipts.<sup>21</sup>

6.22 The calculation of the starting base may utilise either a market value or book value approach. Under these approaches, a starting base amount is calculated in relation to a project interest as at 30 June 2012 based on the value of starting base assets<sup>22</sup> and interim capital expenditure incurred since the assets were valued. Alternatively, a 'look-back' approach may be used, which allows for expenditures incurred prior to the extension of the PRRT to be taken into account.

### *Other new categories of deductions*

6.23 The PRRT Bill will provide some further new categories of deductible expenditures. These include provisions to:

- explicitly provide that expenditure incurred for an environmental purpose is deductible; and
- make payments compensating native title holders, registered native title claimants and certain other persons deductible (currently these payments are not deductible).

6.24 The native title amendment follows a recommendation made by the Policy Transition Group (PTG):

Under the current PRRT provisions, native title payments that are not directly incurred in relation to a petroleum project are not deductible expenditure ... Industry has stated that native title and related access payments should be deductible regardless of the form in which they are made, as operations cannot be conducted without access to land.<sup>23</sup>

### *Fiscal impact*

6.25 The revenue that the extended PRRT will collect is likely to be subject to a number of factors. The deductibility of Commonwealth and state royalties and excise will clearly affect potential PRRT revenue. The allowance for a starting base is also

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21 Petroleum Resource Rent Tax Assessment Amendment Bill 2011, schedule 4, item 10. The detailed provisions for calculating the starting base amounts will be included in a new schedule 2 to the PRRTA Act (schedule 4 to the PRRT Bill).

22 Starting base assets include all types of legal property and rights related to a project interest. The definition is based on that used for a capital gains tax asset under income tax law. See Petroleum Resource Rent Tax Assessment Amendment Bill 2011 and related bills, *Explanatory Memorandum*, p. 74.

23 Policy Transition Group, *Report to the Australian Government: New Resource Taxation Arrangements*, December 2010, p. 107.

likely to have a significant impact in the first few years of the extended PRRT's operation. Reflecting these considerations, the Explanatory Memorandum states that the revenue impact of the PRRT extension is 'unquantifiable'.<sup>24</sup>

6.26 Other reasons for uncertainty arise from the design of the PRRT and market volatility. A number of factors influence PRRT revenue; these include the:

- level of production;
- price of crude oil and petroleum commodities;
- exchange rate; and
- level of investment and exploration (both of which affect deductible expenditures), and changes to the costs associated with these activities.

6.27 As a result of these factors, PRRT revenue is difficult to forecast. PRRT revenue has fluctuated over time and actual revenue has on occasion differed significantly from initial forecasts, as shown by Table 6.1.

**Table 6.1: Estimated and actual PRRT revenue**

Financial year	Estimate at Budget (\$m)	Updated estimate at following year's Budget (\$m)	Actual revenue (Final Budget Outcome) (\$m)
2002–03	1,520	1,720	1,715
2003–04	1,280	1,200	1,165
2004–05	1,100	1,460	1,465
2005–06	1,350	1,970	1,991
2006–07	2,490	1,560	1,594
2007–08	1,980	1,840	1,871
2008–09	2,920	1,600	2,099
2009–10	1,720	1,480	1,297
2010–11	1,860	940	806
2011–12	2,050	n/a	n/a

Sources: Australian Government, *Budget Paper No. 1* (various years); *Final Budget Outcome* (various years).

6.28 Further long-term areas of uncertainty for revenue under an expanded PRRT arise due to the nature of the onshore petroleum industry and likely future developments and production trends in that industry.

24 Petroleum Resource Rent Tax Assessment Amendment Bill 2011 and related bills, *Explanatory Memorandum*, p. 3.

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### ***Compliance costs and number of entities impacted***

6.29 At present, the PRRT applies to a small number of entities. However, there are even fewer actual PRRT liabilities realised. In 2007–08, although there were 65 PRRT registrations and 24 PRRT projects, only ten projects and nine company groups were liable to pay the PRRT.<sup>25</sup>

6.30 The material accompanying the proposed legislation does not provide insight into the number of projects and taxpayers that would be subject to the expanded PRRT. On the likely compliance cost impact, the Explanatory Memorandum states:

The measure is expected to impose significant compliance costs on taxpayers in the onshore oil and gas sectors and the North West Shelf Project. Compliance costs will be high during the first year of the extended PRRT's operation, as taxpayers will need to value their starting base, apply for combination certificates and modify their accounting procedures. Compliance costs will be minimised over the medium term once the extended PRRT has been operational.<sup>26</sup>

### **Committee view**

6.31 Extending the coverage of the PRRT so that it applies to all offshore and onshore petroleum production in Australia will ensure that the community as a whole shares in any above-normal profits that result from the extraction of these non-renewable resources. The PRRT extension will provide a national framework for the taxation of petroleum, resulting in the profits from oil and gas production being treated more consistently regardless of where the extraction takes place.

6.32 The committee notes that the proposal to extend the PRRT has been subject to an extended consultation process as part of the PTG's deliberations in 2010 and the exposure draft consultation undertaken by Treasury in 2011. Additionally, the PRRT has, overall, been operating successfully offshore for over 20 years meaning its characteristics will be familiar to many industry participants and the tax and accountancy professions.

6.33 As a result of the consultation process undertaken by the government in developing the PRRT Bills, the committee's own examination of the bills and the absence of evidence to the contrary being submitted to this inquiry, the committee considers that the provisions that relate to transitioning projects should account for the different characteristics these projects may have, while being consistent with the PRRT's overall design and long-running operation.

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25 Australian National Audit Office, *Administration of the Petroleum Resource Rent Tax*, Audit Report No. 33 2008–09, p. 32; based on ATO information. Figures reflect the number of PRRT registrations and projects as at 3 October 2008, and the number of PRRT group companies and projects that paid PRRT in 2007–08.

26 Petroleum Resource Rent Tax Assessment Amendment Bill 2011 and related bills, *Explanatory Memorandum*, p. 3.

6.34 Having said this, the committee acknowledges that the PRRT is a highly technical tax, and is aware that specific elements of the PRRT have been the subject of long-running disputes and litigation. The committee also wishes to ensure that once the extended PRRT commences, it operates as intended without significant administrative and compliance burdens being placed on the taxpayers transitioning to the PRRT regime or on the Australian Taxation Office.

6.35 Recommendation 93 of the PTG's report called for a review of the extended PRRT within five years of its operation. The committee strongly believes there is merit in a review of the operation and administration of the extended PRRT being conducted at some point after it has commenced and the first PRRT returns have been assessed.