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Australia's Future Tax System Review

Please find attached a submission from the Australian Petroleum Production & Exploration Association (APPEA) in relation to the consultation phase of the review being undertaken into Australia's Future Tax System.

Contact officer should you wish to discuss any matters in further detail is Noel Mullen (nmullen@appea.com.au) tel 02 62670904.

Yours sincerely



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**SUBMISSION TO
"AUSTRALIA'S FUTURE TAX
SYSTEM" REVIEW**

Consultation Phase

**AUSTRALIAN PETROLEUM PRODUCTION &
EXPLORATION ASSOCIATION (APPEA) LTD**

MAY 2009

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Recommendations

Long Life Capital Intensive Investments – Income Tax

APPEA recommends the introduction of substantial modifications to the income tax regime as it applies to gas projects in Australia. This could be achieved through a major reduction in the length of asset lives for depreciation or through the introduction of an investment allowance under the income tax regime. The introduction of a three year write-off period for all plant associated with gas production, liquefaction activities and related greenhouse gas abatement processes would be one such approach.

The Resource Taxation Framework

In the context of the resource taxation framework:

- APPEA supports the retention of the current regimes for existing projects (and incremental investments within those projects);
- in examining the application of a uniform fiscal structure across the entirety of the resources sector, priority is given to providing a stable framework for investors that reduces distortions between competing activities;
- any review considers the full impact of taxation on investments, including income tax and other federal/state charges;
- all upstream resource taxation payments made by the petroleum industry to the Federal Government (petroleum resource rent tax, production excise and Commonwealth petroleum royalties) are reported under a tabulated revenue item in the annual Budget Papers; and
- the petroleum resource rent tax be set as the benchmark for determining tax expenditure estimates in annual data published by Treasury.

Operation and Administration of the Petroleum Resource Rent Tax Regime

APPEA recommends that:

- a formal and ongoing biennial review of the Australian Taxation Office's administration of the PRRT regime be implemented to examine and document the status of unresolved issues and the consistency of advice provided to taxpayers; and
- with a view to providing a forum for clarifying key interpretative provisions of the legislation, a body independent of the ATO be established (possibly chaired by Treasury and with representation from the Department of Resources, Energy and Tourism), to provide advice on both the operation and the policy intent of key provisions of the legislation.

Loss Transferability - Exploration Companies

APPEA recommends the introduction of a modification to the company tax regime to allow eligible entities to transfer exploration deductions to shareholders via the introduction of a tax credit or similar mechanism. Such a scheme could be quarantined to eligible exploration entities or other businesses that face similar tax induced disadvantages.

Licence Fees/Stamp Duties

APPEA recommends the Review Panel examines the feasibility of a phased reduction in stamp duties and licence fees on the transfer of interests and dealings in petroleum titles. In the first instance, rates should be set (and capped) at levels that reflect the administrative cost of registering such dealings.

High Risk Exploration

APPEA recommends the introduction of an investment allowance type deduction under the income tax regime for petroleum exploration in defined frontier areas at a rate of 175 per cent of eligible exploration expenditures.

Capital Asset Pooling

APPEA recommends that the Review Panel examines the options to streamline the record keeping requirements and running balance provisions associated with depreciating assets within projects via a pooling system to streamline costly processes for taxpayers, recognising the need for the maintenance of substantiation systems.

Compliance Measures – Tax Impact Statement

APPEA recommends that a financial impact statement be prepared by the relevant regulatory agency prior to the passage of tax related legislation to quantify the administrative cost of any new measure, with a requirement that the impact of individual measures be further reviewed within a defined period following introduction.

Avoidance of Double Taxation

APPEA recommends that the Review Panel carefully considers international taxation implications and the potential incidence of double taxation of any reform proposals.

Section 1: Background and Competitiveness

"Clearly, the time has well and truly come to look at the design of our tax-transfer system and embark on a fresh reform path to improve equity and efficiency in the tax system and position us to meet future challenges. To achieve the purposes we set, we need a tax system that is international competitive so it can create jobs, that rewards hard work, and that is simpler and more equitable."

The Hon. Wayne Swan MP, Federal Treasurer, 25 February 2009

1.1 Introduction

The Australian Petroleum Production & Exploration Association Ltd (APPEA) is the peak national body representing the oil and gas exploration, development and production industry in Australia. The Association's membership comprises companies that account for an estimated 98 per cent of Australia's petroleum production, the vast majority of exploration, as well as many entities that provide support services to the industry.

An expansion of Australia's oil and gas industry can deliver major economic and environmental benefits to Australia. In addition to potential multi-billion dollar expenditures on capital goods and equipment, a growing oil and gas industry can employ many thousands of workers and support a vast array of other businesses. While providing a strong basis for long term private infrastructure capacity, the industry can also assist in underpinning government revenue collections for many decades into the future, and greatly assist in obtaining major reductions in greenhouse gas emissions both in Australia and the Asia Pacific region. The recommendations contained in this submission seek to obtain these benefits.

The petroleum industry in Australia is diverse in size and focus. The structure ranges from small and medium-sized Australian listed companies to global corporate entities. Many companies have little or no production, while others sell oil and gas into domestic and/or global markets. The industry undertakes activities in a wide range of geographic regions, many of which are in remote areas with little, if any, infrastructure.

To date, oil prospectivity in Australia has generally been perceived to be marginal, with relatively low discovery rates and small average field sizes. Gas prospectivity is good, both in terms of conventional and coal seam gas. Despite this, large gas resources remain undeveloped, often decades after discovery. Gas discoveries are often remote from markets and infrastructure and therefore can be difficult to commercialise. The fiscal system influences investment decisions in the industry and settings must be such that they do not act to discourage exploration and development decisions. Capital is mobile globally – funds not spent in Australia will more often than not be redirected to other countries.

APPEA's submission to the first phase of the review focused on ensuring that the nation is in a position to maximise the contribution that our petroleum resources can play towards Australia's economic well-being (a copy of the Recommendations from our initial submission are at Attachment 1). APPEA notes that while the primary objective of the review is to "...conduct a comprehensive review of Australia's tax system to create a tax structure that positions us to deal with the demographic, social, economic and

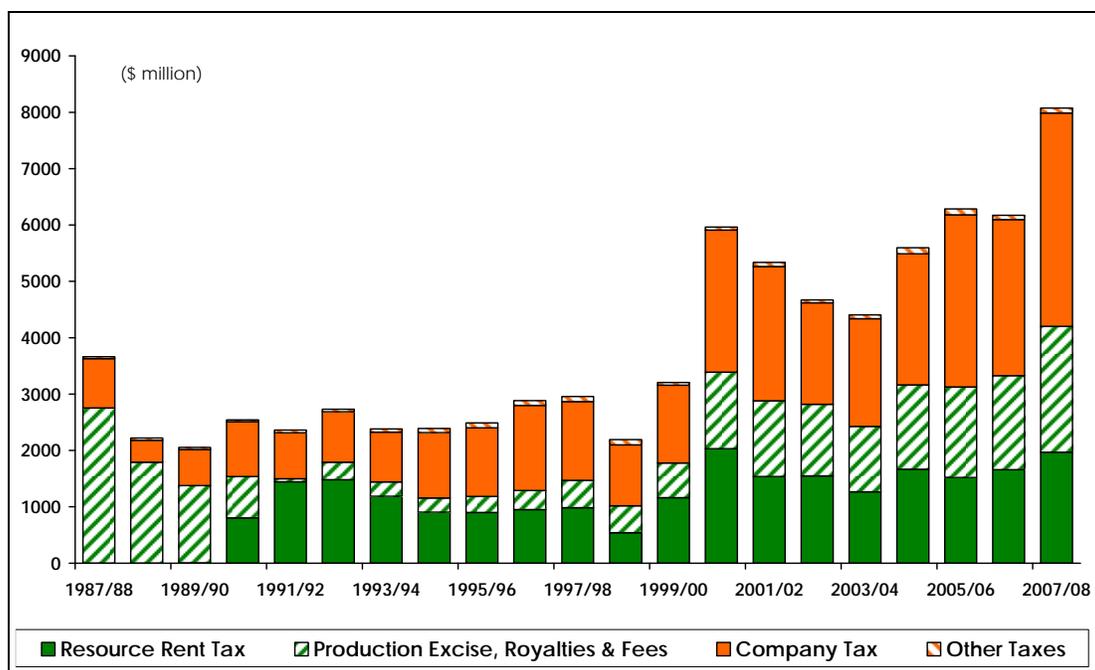
environmental challenges of the 21st century, it is being undertaken at a time of profound global economic challenges.

Australia's petroleum resources have the potential to help meet both domestic economic and global environmental objectives. Individual projects can generate significant levels of government revenue, create many thousands of jobs and billions of dollars in export income, while Australia's gas production represents a key part of our global environmental response. It is important that the tax system encourages the investment of capital and provides a long term platform for confidence in decision making.

1.2 Taxation and the Petroleum Exploration and Production Industry

The taxation framework that covers activities undertaken in the petroleum industry in Australia is varied. Income tax applies to business income, all petroleum production is subject to resource taxation (see below), and a myriad of indirect taxes also apply to the industry's activities, including customs duties, licence fees, stamp duties (and associated transaction charges), fuel taxation and GST.

Chart 1: Taxation Payments - Petroleum Exploration and Production Industry



Source: APPEA Financial Survey

The fiscal framework plays a key role in shaping investment decisions in the industry. Data collected by APPEA that measures the financial performance of the sector indicates that taxation makes up 35 per cent of the total costs incurred by the industry (\$8.1 billion out of a total cost base of \$23.2 billion for the year 2007-08). Chart 1 outlines both the quantum of taxation paid by the industry and the distribution of payments.

In terms of resource taxation, a variety of regimes exist:

- the petroleum resource rent tax (PRRT) applies to all 'offshore' projects (projects under Commonwealth jurisdiction), with the exception of those production licences derived from Exploration Permits WA-1-P and WA-28-P;

- production sourced from licences derived from Exploration Permits WA-1-P and WA-28-P are subject to Commonwealth crude oil and condensate excise and Commonwealth petroleum royalty; and
- onshore production and that sourced from projects located in submerged lands under state/territory jurisdiction is subject to Commonwealth crude oil and condensate excise and royalty under the relevant state/territory jurisdiction. The royalty provisions for each jurisdiction are often varied in their detail.

The layered nature of the taxation structure (resource, income and indirect) and the involvement of multiple jurisdictions creates considerable complexity. A range of issues are outlined in further detail in Section 2.

1.3 How Competitive is the Australian Fiscal System?

An internationally competitive fiscal regime is crucial to increasing Australia's share of global exploration activity, facilitating the development of new projects, and extending the productive lives of mature developments. Modifications to taxation settings may not alone lead to changes in project decisions, however competitive fiscal terms improve the overall decision making framework. Fiscal policy is one of the few policy instruments within the control of governments that can be used to encourage investment activity. In terms of Australian gas projects, the lower returns, long lead times and high risks associated with such activities lend themselves to economic improvements through taxation changes.

As noted above, APPEA data indicates that taxation accounts for more than a third of the total costs incurred by the industry in Australia. A number of independent studies have been conducted that assess how Australia stands relative to competitor nations. It is important to remember who our competitors are. Comparisons are often based on OECD countries which is not appropriate for activities in the petroleum industry where the majority of Australia's direct competitors (including for the supply of LNG into the Asia-Pacific Region) are non-OECD countries.

1.3.1 Global Tax Comparisons – Australia versus other Gas Producing Nations

PricewaterhouseCoopers has undertaken a comprehensive global analysis into key aspects of income tax regimes world wide on corporate activities. The review, which was conducted as part of the World Bank's 'Doing Business' project, covered 181 countries and measured the following:

- 'Ease of paying'
- The number of tax payments made during a year
- Time required to comply
- The total tax rate

Table 1: Total Tax Rate (percentage of commercial profits) – Selected Gas Producing Countries

Country	Overall Ranking
Qatar	3rd
UAE	4th
Saudi Arabia	6th
Oman	15th
Nigeria	39th
Trinidad & Tobago	43rd
Malaysia	53rd
Indonesia	72nd
Brunei	73rd

Norway	88th
Papua New Guinea	89th
United States	92nd
Egypt	109th
Australia	127th
Algeria	167th

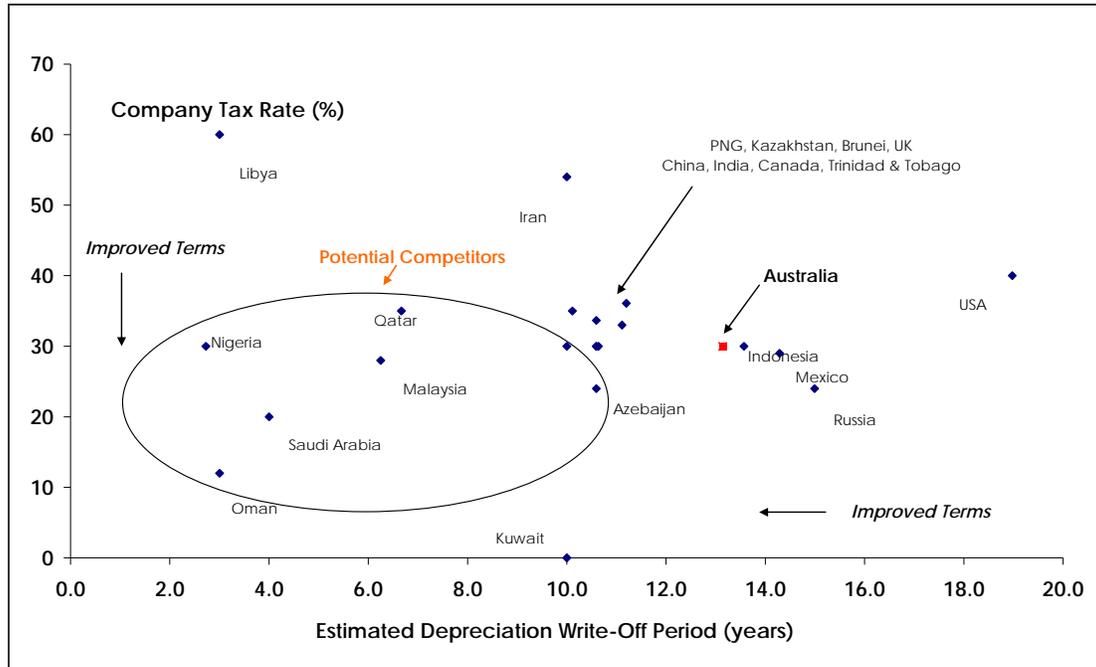
Source: PricewaterhouseCoopers, "Paying Taxes 2009 – The global picture"

The rankings are based on a generic business case study that was prepared and applied to each tax paying jurisdiction. Australia performed relatively well in the first three measures (ranking 68th, 33rd and 25th respectively), however when measured on a total tax rate basis (as a percentage of commercial profits), Australia ranked 127th. This result is even worse when Australia is compared directly with other gas producing countries – under this scenario, Australia ranks second last (see Table 1).

1.3.2 Tax Rate/Depreciation Comparison

While there are elements of the PricewaterhouseCoopers study that necessitate some caution when making direct comparisons between countries, the overall poor ranking of Australia is significant. A similar trend is evident in a review undertaken in 2006 for APPEA by KPMG and that was presented in our first submission.

Chart 2: Company Tax Rate/Depreciation Comparison – Gas Projects



Source: APPEA Strategic Leaders' Report/KPMG

The study of company tax and depreciation arrangements for countries that have provisions covering gas related activities was undertaken to inform discussions associated with the development of a strategic plan to maximise the growth potential of Australia's petroleum resources (*Platform for Prosperity: Australian Upstream Oil and Gas Industry*, April 2007 – see www.appea.com.au). The study covered a variety of countries spanning a diverse selection of gas producing jurisdictions. Again, while some caution needs to be exercised in making detailed comparisons between individual jurisdictions, some clear trends are evident.

The depreciation axis attempts to factor in the special incentives that have been introduced by some countries, including investment allowances or accelerated depreciation (or both) to encourage investment in gas plant and equipment. Chart 2 shows that Australia performs below average when compared with many of our competitors. While we are around average in relation to the tax rate, we do not perform well in terms of depreciation.

In the context of the headline tax rate, APPEA notes that in the Background Paper released in August 2008 to inform the Tax Review process (*Architecture of Australia's tax and transfer system*), a comparison of company tax rates across a range of OECD countries highlights that since 2001, there has been a movement downwards in many jurisdictions, with the average rate in 2008 being 26.6 per cent.

1.3.3 Income Tax Impact on Long Life Investments - Gas Projects

Some of the largest gas discoveries in the world have been made in Australia, yet much of this discovered gas remains undeveloped. In APPEA's earlier submission, we drew attention to 2005 commentary from analysts Wood Mackenzie Ltd that examined the reasons why many of Australia's gas projects had not been developed. They concluded that:

"(f)or a number of reasons, the economics of large gas projects offshore Australia are fundamentally different from typical oil projects. While the PRRT regime is progressive, the very long depreciation schedule for federal income tax can create a very high government take, when considered on a discounted basis, as investors are likely to do. This has the effect of driving up the breakeven price for the large, stranded gas projects – making them potentially less attractive than other projects in the region.

With oil prices as high as they are, it may appear odd that investors in the petroleum industry could be seeking tax incentives. As this article demonstrates, however, gas is not oil, and the economics of the large gas discoveries continue to appear marginal to investors, even when oil prices are high. While securing a high gas price will remain the investor's primary objective, the Government may wish to consider reducing its take from large gas projects, if it wishes to stimulate development of its gas resources. The most obvious element to review would be the federal income tax depreciation schedule, which appears anomalously slow in comparison to fiscal regimes elsewhere."

A further report was commissioned by a number of APPEA member companies in late 2008 to provide an up to date snap shot of the impact of current fiscal terms on oil and gas economics in Australia. The summary slide below provides some key conclusions.

www.woodmac.com

Impact of Tax Regime on Oil and Gas Economics

Summary of Australian fiscal terms

- › Offshore oil and gas production is subject to Petroleum Resource Rent Tax (PRRT, which is payable on net profits at 40%, once certain returns are deemed to have been achieved) and federal income tax (FIT). The exceptions to the rule are the North West Shelf (NWS) gas project, which is subject to royalty and FIT and "inshore" projects, which are subject to the relevant state royalty, excise duty and FIT.
- › FIT is payable at 30% of net profits, which is gross revenue less operating costs, royalty and excise (if applicable) and depreciation of capital costs. Under current rules, capital costs are depreciated over the useful life of the asset, which for large gas projects can be 20-30 years, resulting in very slow depreciation rates. Most fiscal regimes provide for depreciation rates of between 2 and 10 years for upstream capital expenditures. For example, capital costs are depreciated over 6 years in Norway (or 3 years in the case of the Snøhvit LNG project), 7 years in the USA and in the UK investors can claim 100% of their upstream capital expenditure in the year it is incurred.
- › PRRT allows investors to recover all of their costs before any tax is paid whereas the depreciation rules mean that a liability to FIT can be generated in the early years of production and this is emphasised for large projects, with very slow depreciation rates.
- › Under a low upstream gas price assumption (US\$2.78/mmbtu), the large gas project would not be liable to PRRT, as the project never overcomes the threshold rate of return (5% + LTBR on development costs) which triggers such payments. However, under the higher prices both PRRT and FIT are payable, providing a lifetime Government Take of up to 56% of the pre-take cash flow (i.e. gross revenue less costs) in nominal terms.

Wood Mackenzie
11
Delivering commercial insight to the global energy industry

Source: Wood Mackenzie, 2008

The report confirmed the findings of the earlier study that income tax is payable well before an investor has recouped the investment costs associated with gas projects and that the early payments of income tax can lead to the government take exceeding 100 per cent of a projects net present value. Further conclusions from the study are available at Attachment 2.

1.3.4 Investment in Long Life Assets – The Tax Impact

A structural bias is inherent within the income tax system. The net present value of costs which can be immediately deducted (for example, operating costs) are greater than the net present value of plant and equipment costs, which are generally depreciated at historical cost and often over very lengthy periods of time. The result is that a dollar spent on operating related activities can be more tax effective than a dollar spent on capital. This favours industries which are non-capital intensive in nature, with little or no account being taken of project or investment risk.

The negative impact of long write-off periods for plant and equipment is compounded by the mismatch in timing between when expenditures are incurred and when a tax deduction can start to be claimed. While the general principle of 'installed ready for use' forms the basis of when tax depreciation starts for eligible plant, it is relevant in an economic context to understand that the value of capital can start to diminish prior to commencement of production. For example, in the case of large projects (such as those associated with gas developments), expenditures can be incurred up to five years prior to the commencement of physical production.

APPEA examined the taxation contribution made by a single large scale gas project through a detailed case study, the results of which were presented in our earlier submission. The analysis was based on a two train LNG plant, serviced by an offshore platform and producing 10 million tonnes per annum of LNG over a 27 year project life. Simulations were conducted to highlight both the underlying economics of the project and the impact of changes in key fiscal parameters.

In summary, the key findings included the following:

- under the base case scenario, a project internal rate of return of 11.8 per cent was generated (highlighting the marginal nature of such projects);
- income and resource taxes accounted for 64 per cent of the total project returns, as measured by project NPV plus tax payments;
- nearly 90 per cent of the total tax paid from the project is in the form of company tax;
- government tax take in undiscounted terms approaches \$40 billion over the life of the project (nearly \$1.5 billion per annum); and
- modifications to key fiscal parameters were modelled, with a five year depreciation life leading to an improvement in project returns.

The findings of the study highlighted that large scale gas projects generate massive revenues for governments over very lengthy periods (often for many decades). An important result was the impact that income tax has on the project. 90 per cent of the total tax paid by the project was from income tax, clearly demonstrating that this form of fiscal impost is crucial in shaping project decisions. In addition, the results of both this and other studies into the economics of large scale gas developments indicate that such projects can underpin the creation of many thousands of jobs across Australia.

The findings on international competitiveness and the total contribution from projects are relevant to question 14.1 posed by the Consultation Paper, "*When considering the appropriate return to the Australian community for the use of non-renewable resources, what relative weight should be given to the determinants of that return?*"

The Australian community must recognise the total benefits enjoyed by the exploitation of non-renewable resources, rather than focus narrowly on a single component of the return, (such as a specific resource tax), and acknowledge that only by developing the resources will the community enjoy any return. As previously identified by APPEA, the benefits of projects are numerous and include foreign exchange receipts, employment (including tax on employment income), investment in infrastructure, income tax, resource taxes, payroll tax, contributions to community programs, GST, economic multiplier effect on wider economic activity, security provided by self-reliance on energy and greenhouse benefits related to Australia having an abundance of clean gas.

If the benefits are to be enjoyed, then the fiscal regime needs to be internationally competitive in order to attract the risk capital required to exploit the resources. This should ultimately determine the return that the community can expect from the use of its non-renewable sources. As we have previously stated, a principal determination of international competitiveness that Government can influence is the total fiscal regime.

In addition, whilst resources are non-renewable, the on-going return to the community from the use of non-renewable resources is influenced by how and when the community re-invests those returns.

2. Issues and Recommendations

2.1 Key Consultation Issues

The Consultation Paper sets the framework for the current phase of the review process and poses a series of questions for stakeholders to focus upon in the preparation of submissions. APPEA's comments have been developed in the context of the questions below:

Q.6.1: Can the tax system be structured to better attract investment to Australia in a way that increases national income, and if so how?

Q.14.2: What is the most appropriate method of charging for Australia's non-renewable resources, given they are immobile but that Australia needs to compete globally for mining investment?

While there are other issues raised in the Consultation Paper that impact on operations of companies engaged in petroleum activities in Australia, the above are seen as being essential in underpinning and attracting investment in the industry.

The recommendations contained in this submission have been assessed against the following two criteria:

1. Do the reforms improve the international competitiveness of the Australian taxation system?
2. Will they lead to an improved framework for investment in the upstream oil and gas industry?

2.2 The Taxation Treatment of Natural Resource Assets

2.2.1 The Resource Taxation Framework

There are numerous resource taxation regimes in place across Australia. The diversity largely reflects the division of powers that exist between the Commonwealth and state/territory governments with respect to resource taxation. They range from profit based systems (PRRT and the Barrow Island resource rent royalty) to those assessed on a unit of production basis (production excise). The historical development of the overall framework has also partly been responsible for the diversity in structure.

The Consultation Paper (Chapter 14) discusses the relative merits of the existing systems, recognizing that each has differing strengths and weaknesses from the perspective of both investors and governments. The question is posed as to what is the appropriate method for charging non-renewable resources, recognizing that Australia must compete globally for investment capital. The petroleum industry is well placed to comment on this important area as it must operate within the full range of systems that are currently in place in Australia, as well as others that apply in overseas jurisdictions.

In evaluating any individual tax or charge, the normal criteria for assessing taxes (equity, efficiency and simplicity) also provide a useful reference framework. In terms of equity and efficiency, the current mix of differing systems can lead to distortions. For example, the differential taxation treatments that apply to coal and gas production can impact on the relative ability of these products to compete in the supply of fuel for the domestic electricity market.

Whether an individual tax or charge will create an insurmountable financial impediment to the development of a resource project will inevitably need to be examined on a case by case basis, however charges levied on a per unit of product basis (or where little consideration is given to project costs) clearly have the potential to negatively impact on project economics. So too will the rate at which any profit based tax is imposed. Ultimately the rate of tax is as important as the method of determining the liability. In particular, it is noted that the PRRT regime, originally designed around oil projects but applied without change to gas projects, has had a significantly different impact on investment decisions in respect of gas than for oil. (APPEA remains concerned about the impact of certain elements of the PRRT regime on gas projects). The design and rates of any profit based tax applied onshore would need to recognize the key economic parameters of such projects, rather than simply apply an existing profit based tax model.

In terms of complexity, the most straightforward regimes are those where a charge is levied as a percentage of either production or sales value (although the differing details of each system causes complexity for companies operating in multiple jurisdictions), while the most complex are generally profits based systems, where delays or uncertainties in defining key terms can create uncertainties for investors. In this latter case, the involvement of the taxation authorities (the Australian Taxation Office) in interpreting operative provisions of the PRRT regime has been an important factor in creating complexity in the operation of that system. The difficulty for profits based systems in adapting to the ever evolving commercial and technical framework for industry also presents challenges. The movement of the Australian petroleum industry from predominantly oil to gas based projects is an example of this situation.

In APPEA's submission to the first phase, it was recommended that any review of the taxation and non-taxation measures that apply to resource extraction activities in Australia should be undertaken within the following parameters:

- project proponents be fully consulted to ensure that the impact of revised measures on individual projects are fully considered;
- impacted industries are fully engaged in the consultation process to assess the Australian and global competitiveness implications of any reforms; and
- a whole of resources sector approach forms the basis of any review of the secondary taxation regime for the resources sector to ensure commodity distortions are not created (or worsened) as a result of any reform process

Overarching any review is the need to recognize that significant investment decisions have been made on the basis of underlying fiscal settings and it is essential for governments to consider the adverse impacts that any changes will have on producer returns, project certainty, future investment decisions and the perceptions of sovereign risk.

APPEA acknowledges the case that is made in the Consultation Paper for a review of the operation of the current resource taxation systems in Australia. Such a review must be wide ranging in nature and we remain strongly of the view that it should involve extensive stakeholder consultations to ensure that governments are fully aware of the positive and negative impacts of possible reforms.

In terms of the potential adoption of a profits based type system across the entirety of the resources sector (petroleum and non-petroleum activities), APPEA has concerns about using the existing PRRT regime as the preferred model. We have reservations with both the appropriateness of certain key operational aspects of the regime and the uncertainties associated with a number of interpretative aspects of the legislation that continue to cause difficulties for project proponents (see below).

Recommendation

In the context of the resource taxation framework:

- *APPEA supports the retention of the current regimes for existing projects (and incremental investments within those projects);*
- *in examining the application of a uniform fiscal structure across the entirety of the resources sector, priority is given to providing a stable framework for investors that reduces distortions between competing activities;*
- *any review considers the full impact of taxation on investments, including income tax and other federal/state charges;*
- *all upstream resource taxation payments made by the petroleum industry to the Federal Government (petroleum resource rent tax, production excise and Commonwealth petroleum royalties) are reported under a tabulated revenue item in the annual Budget Papers; and*
- *the petroleum resource rent tax be set as the benchmark for determining tax expenditure estimates in annual data published by Treasury.*

2.2.2 Operation and Administration of the Petroleum Resource Rent Tax Regime

PRRT has many features that differentiate it from both income tax and many other resource charges. These differences include a variety of transferability rules, the immediate deductibility of eligible costs, carry forward provisions (including compounding rules) and the taxing unit being assessed on a 'project' basis. Overall, PRRT has the basic design features of an economic tax rather than an accounting tax or simple excise/royalty systems. This is confirmed in the Review's Background Paper.

As PRRT is categorized as a tax, it is administered by the Australian Taxation Office, while primary policy responsibility rests with Treasury. APPEA provides a coordinated stakeholder forum for engagement with the Government, with most companies with activities covered by the regime being members of the Association. With a relatively narrow taxpayer base, consultations associated with the design, administration and technical aspects of the provisions can be well targeted. However, the legislation is becoming subject to increased disputation and litigation, which is leading to uncertainty for participants in the industry. APPEA notes that the Australian National Audit Office is currently undertaking a comprehensive review the ATO's administration of the regime.

In our earlier submission, a variety of compliance and administrative concerns were raised, including:

- lack of clarity with some important aspects of the legislation;
- lengthy delays are becoming common in resolving matters in dispute;
- a general lack of policy direction, with the ATO applying income tax interpretations to what is an economic tax;
- the changing focus of the industry from oil to gas which is causing difficulties in relation to some aspects of the legislation; and
- lack of a regular process to modernize the legislation.

The examples cited in APPEA's earlier submission of continued uncertainty surrounding the scope of 'indirect' and 'administrative' costs and definitional aspects of 'feasibility assessment costs' still remain unresolved.

Emerging issues need to be addressed, which in APPEA's view, can only be satisfactorily and expeditiously addressed through examining (and possibly revisiting) the issues in the context of the policy intent of the regime. Fundamentally, applying income tax principles to what is an economic tax has the potential to generate entirely inappropriate outcomes.

Recommendation

APPEA recommends that:

- a formal and ongoing biennial review of the Australian Taxation Office's administration of the PRRT regime be implemented to examine and document the status of unresolved issues and the consistency of advice provided to taxpayers; and
- with a view to providing a forum for clarifying key interpretative provisions of the legislation, a body independent of the ATO be established (possibly chaired by Treasury and with representation from the Department of Resources, Energy and Tourism), to provide advice on both the operation and the policy intent of key provisions of the legislation.

2.3 Income Tax

2.3.1 Long Life Capital Intensive Investments – Income Tax

Section 1.3 outlined a number of concerns with the competitiveness of the income tax regime for gas projects in Australia that APPEA considers need to be addressed.

A number of important changes to the capital depreciation regime have been made over the last decade. The system of accelerated depreciation was largely abolished in 1999 and replaced by the 'effective life' principle in determining the life of assets for income tax purposes. This change, which was recommended as part of the Ralph Review process, was accompanied by a reduction in the head line tax rate. Subsequently, 15 to 20 year statutory caps were introduced for oil and gas assets in 2002, which was followed in 2006 by a business-wide increase in the diminishing value rate for determining depreciation deductions.

Currently, the tax life of an asset for depreciation purposes in the oil and gas industry can be calculated in one of three ways:

- the life outlined by the Commissioner of Taxation in the published schedule of asset lives; or
- the statutory caps set by legislation—15 or 20 years depending on the nature of the asset; or
- self-assessed by the taxpayer, based on the estimated life of the asset.

APPEA considers that the current provisions remain unresponsive to the economic factors that affect long-life gas projects, as well as the need to remain globally competitive. The introduction of the 2002 and 2006 modifications, while somewhat dampening the negative impact of the 1999 abolition of accelerated depreciation, do not place Australia in a position where our income tax terms compare favourably with our competitors. In addressing Question 6.1 in the Consultation Paper, reforms can and should be implemented that can make Australia a more attractive place to invest funds in long life capital assets.

The international comparisons outlined in Section 1.3 demonstrate that reforms are critical if we are to improve Australia's competitive position. A spreading in the company tax burden on long term gas projects through a reduction in the lives over which capital assets can be claimed is particularly effective. It will have a relatively low cost to revenue for the government in the short term (deductions are claimed when plant is ready for use), but it will provide an important stimulus to project economics through an improvement on a net present value basis. Alternatively, a reduction to the company tax rate could act in a manner to achieve a similar benefit.

Recommendation

APPEA recommends the introduction of substantial modifications to the income tax regime as it applies to gas projects in Australia. This could be achieved through a major reduction in the length of asset lives for depreciation or through the introduction of an investment allowance under the income tax regime. The introduction of a three year write-off period for all plant associated with gas production, liquefaction activities and related greenhouse gas abatement processes would be one such approach.

2.3.2 Loss Transferability - Exploration Companies

There is a diverse range of participants in the Australian upstream petroleum industry. While some have access to production, many are reliant on the equity market to fund on-going exploration in Australia and, increasingly, in other parts of the world where the risk-reward framework and access provisions are often perceived to be more attractive.

The role played by junior petroleum exploration companies is important to the overall health and vitality of the sector, in a similar way that small businesses underpin the national economy. While exploration by small oil and gas entities represents a relatively modest proportion of the total pool of funds spent on petroleum exploration, it is a key element of the overall effort. Junior explorers have shown an ability to identify, explore and develop petroleum resources at a scale that does not necessarily attract larger entities. This has led to both new discoveries and incremental production from declining fields. The diversity in size and activity among participants in the Australian petroleum industry has been a major contributor to its success. A number of Australia's larger oil and gas discoveries have resulted from the innovative and pioneering work undertaken by junior exploration companies, while the growing commercial viability of coal seam gas reserves in Eastern Australia demonstrates the role played by such explorers.

The challenges confronting small to mid sized Australian companies in raising capital to fund exploration have increased markedly of recent times as the impact of the global financial crisis bites deeply. Numerous recent media reports and public announcements by companies have highlighted the difficulties being encountered by these entities in raising funds.

For companies that have an income tax liability, the ability to immediately expense costs, such as those associated with exploration activity, provides an important form of cost relief. Entities that do not have adequate or have no income are unable to obtain tax relief and are therefore required to carry deductions forward. As a direct consequence, this inability to obtain a tax deduction means that the after tax cost of exploration is significantly higher for these companies. APPEA considers the most appropriate way to address this situation is through allowing an eligible entity to transfer its entitlement to a deduction to shareholders at the time the deduction is incurred. One method would be for a deduction to be claimed via a 'tax credit' based on the prevailing company tax rate at the time the expenditure is incurred (similar to the principles that underpin the existing franking system). All investors in eligible companies, whether they are individuals, corporate entities or superannuation funds, would be treated in a consistent manner.

The Government's in-principle recognition of the case for such a system in their 2007 election platform was the first important step in recognising the importance of such an initiative. In consultation with the minerals industry and other stakeholders, a proposed framework has been developed by APPEA and is outlined at Attachment 3. The model would:

- encourage companies to undertake exploration for petroleum in Australia;
- minimises administrative costs for companies, regulators and investors;

- avoids distortions between shareholders;
- reduces compliance costs; and
- minimise risk for investors and regulators.

Further analytical work is being developed by mining and petroleum industry representatives to highlight the benefits associated with junior exploration and the potential revenue implications of implementing a flow through share system.

Recommendation

APPEA recommends the introduction of a modification to the company tax regime to allow eligible entities to transfer exploration deductions to shareholders via the introduction of a tax credit or similar mechanism. Such a scheme could be quarantined to eligible exploration entities or other businesses that face similar tax induced disadvantages.

2.4 Other Proposed Reforms

2.4.1 Licence Fees/Stamp Duties

Activities in the petroleum industry are undertaken within a complex regulatory and financial framework, covering activities ranging from bidding for exploration permits to commercial production decisions. The nature of the industry's activities often leads to the use of joint ventures to spread risk, facilitate project funding and to share technical and commercial expertise between project partners. With the growing maturity of the Australian industry in terms of the breadth of acreage released and expanding market opportunities, there is a growing trend for project licensees to examine opportunities for project re-alignment to best capture commercial opportunities, improve project economics and generate economies of scale. The efficient development of resources can sometimes be optimized through the introduction of new partners or joint venture restructuring. The size of many projects in the industry and the scale of resources in place can see high monetary values being placed on such re-alignments and transactions.

A variety of duties and fees apply to the transfer of titles and interests in petroleum permits and licences, with rates depending on the nature of the transaction and the relevant jurisdiction. The imposition of such charges can influence (and potentially deter) the decisions of parties to enter into such transactions. This can lead to sub-optimal resource development decisions.

Recommendation

APPEA recommends the Review Panel examines the feasibility of a phased reduction in stamp duties and licence fees on the transfer of interests and dealings in petroleum titles. In the first instance, rates should be set (and capped) at levels that reflect the administrative cost of registering such dealings.

2.4.2 High Risk Exploration

A strong and globally competitive domestic exploration sector is crucial to the long term future of the industry as well as ensuring that the nation remains capable of producing reliable clean energy and substantial wealth for all Australians. To achieve this objective, it is important that Australia seeks to achieve high level, but realistic exploration targets. A

priority is to increase exploration in onshore and offshore frontier areas. At present, it is estimated that only 17 per cent of Australia's offshore sedimentary basins and 26 per cent of potentially prospective onshore basins are covered by petroleum permits. We simply do not know what resources remain to be discovered. This issue has become even more important with the recent extension of Australia's Exclusive Economic Zone.

Offsetting the enormous unexplored potential in Australia's frontier areas are our relatively low commercial discovery rates, extremely high rig mobilisation costs and concerns about approvals processes. These factors need to be recognised and offset by fiscal settings that respond to the additional risks associated with exploring in frontier areas. The designated frontier area PRRT incentive that was introduced in 2004 and that will cease following the release of the 2008 offshore acreage has been of negligible benefit. Industry believes that a mechanism connected to the company tax system will provide a more appropriate stimulus.

Recommendation

APPEA recommends the introduction of an investment allowance type deduction under the income tax regime for petroleum exploration in defined frontier areas at a rate of 175 per cent of eligible exploration expenditures.

2.4.3 Capital Asset Pooling

The taxation laws contain a variety of provisions for the tax treatment of capital expenditures. This invariably involves complexity in the interpretation of tax laws and requires taxpayers to maintain numerous records to track the depreciated value of assets for income tax purposes. For large projects, this can involve hundreds or thousands of individual records and associated running balances, many of which have relatively low values.

Recommendation

APPEA recommends that the Review Panel examines options to streamline the record keeping requirements and running balance provisions associated with depreciating assets within projects via a pooling system to streamline costly processes for taxpayers, recognising the need for the maintenance of substantiation systems.

2.4.4 Compliance Measures – Tax Impact Statement

Numerous requirements and obligations are placed on taxpayers in terms of complying with the tax system, particularly in relation to income tax and GST. In many cases, while the risk to revenue may often be low, the compliance obligations can be complex or costly on taxpayers. A review of the impact on taxpayers of requirements in meeting tax related reporting or compliance procedures should be mandatory prior to the passage of legislation.

Recommendation

APPEA recommends that a financial impact statement be prepared by the relevant regulatory agency prior to the passage of tax related legislation to quantify the administrative cost of any new measure, with a requirement that the impact of individual measures be further reviewed within a defined period following introduction.

2.4.5 Avoidance of Double Taxation

Companies undertaking activities globally must deal with the effects of both foreign taxes and the home country tax treatment of foreign income. Double taxation is a factor that must be considered when an entity considers international operations, and is particularly relevant in instances where the same income is taxed more than once. As the petroleum industry is highly globalised in nature, the impact of a country's taxation framework that fails to address the potentially adverse consequences of double taxation may lead to funds being directed to competing jurisdictions.

For Australia, investment in large scale projects will often involve overseas companies investing outside of their home jurisdictions. For these companies, paying Australian tax may simply displace tax they would pay in their home jurisdictions. While this may be the case where Australian tax paid is a creditable tax (broadly speaking profit based taxes that are not proxies for rent are creditable taxes), some resource taxes are typically not creditable and so represent real imposts on projects. This must be taken into account in the development of tax settings to position Australia in an international context.

Recommendation

APPEA recommends that the Review Panel carefully considers international taxation implications and the potential incidence of double taxation of any reform proposals.

Attachment 1

APPEA Recommendations: 1st Phase of the Review Process

1. Investment in Gas Projects

The Government introduces substantial modifications to the company tax regime as it applies to gas projects in Australia. This could be achieved through a major reduction in the length of asset lives for depreciation or through the introduction of an investment allowance under the income tax regime. The introduction of a three year write-off period for all plant associated with gas production, liquefaction activities and related greenhouse gas storage processes would be one such approach.

2. Exploration Framework

The Government introduces an investment allowance type deduction under the company tax regime for petroleum exploration in frontier areas at a rate of 175 per cent of eligible exploration expenditures. Modifications to the company tax regime be introduced via the adoption of a flow through share mechanism to assist junior exploration companies in raising equity capital to undertake exploration.

3. Resource Taxation Framework

Any decision by governments to review the resource taxation and non-taxation measures address the following:

- project proponents be fully consulted to ensure that the impact of revised measures on individual projects are fully considered;
- impacted industries are fully engaged in the consultation process to assess the Australian and global competitiveness implications of any reforms; and
- a whole of resources sector approach forms the basis of any review of the secondary taxation regime for the resources sector to ensure commodity distortions are not created as a result of any reform process.

4. Administration and Operation of the PRRT Regime

Treasury and the Department of Resources, Energy and Tourism become more actively engaged in providing policy and interpretive guidance on the operation of the PRRT regime with the ATO's role being limited to administrative and compliance issues.

5. Assessment of the Administrative Impact of Taxation Measures

The Review Panel examines the necessity of administrative processes imposed on taxpayers in meeting obligations under the income tax system in circumstances where the risk to revenue is low and compliance obligations are either complex or costly on taxpayers. In particular, an impact statement should be prepared for all tax measures where taxpayers are required to implement structures to comply with provisions under income tax legislation. These impact statements (including the risk to review of their removal) should be reviewed on an on-going basis for each taxation measure.

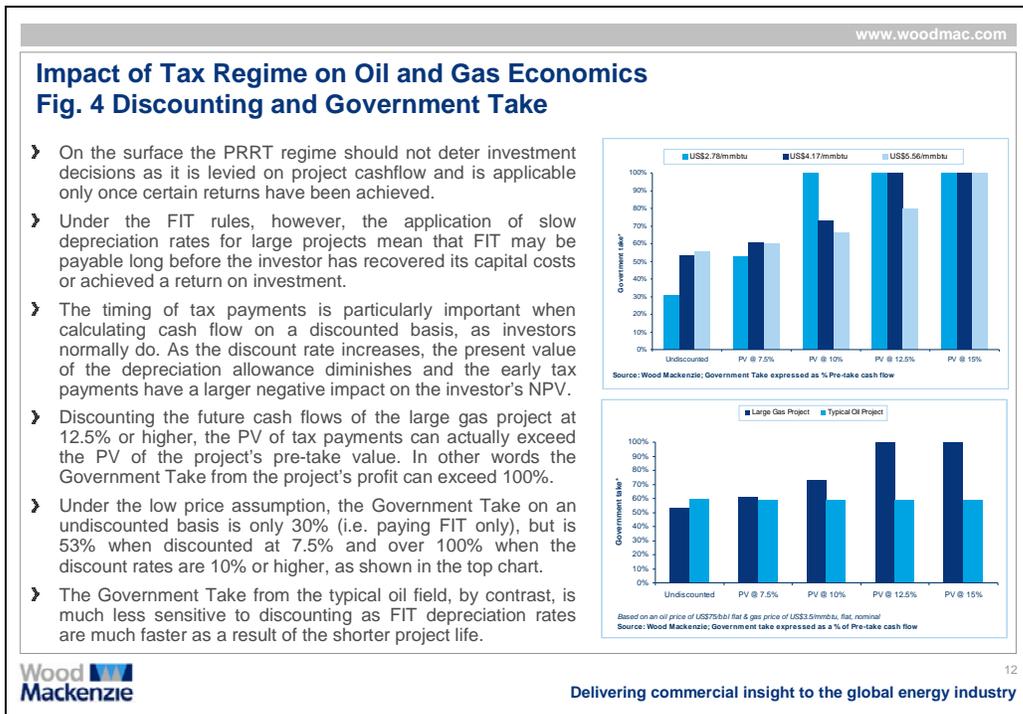
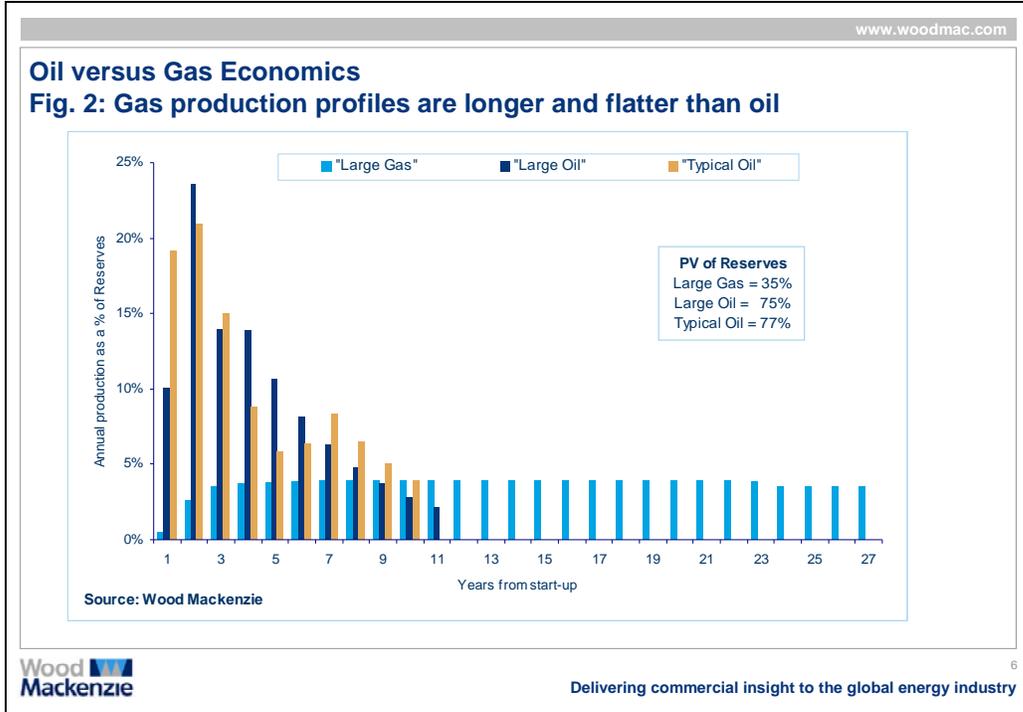
6. *Taxes on Business Inputs*

Governments move to abolish or reduce the incidence of charges that apply to business transactions and that when retained, such imposts be levied at a level to cover the administrative costs of undertaking service activities.

7. *Goods and Services Tax*

The Government periodically reviews the operation of the GST regime to ensure the key provisions remain consistent with the nature of commercial practices in industry and that compliance and administrative obligations do not impose unnecessary burdens on taxpayers where there is minimal risk to revenue.

Selected Results: Wood Mackenzie Study (2008)



Attachment 3

Petroleum Resource Taxation Settings in Australia

Petroleum Resource Rent Tax (PRRT)

The petroleum resource rent tax (PRRT) is the primary resource taxation mechanism that the Australian Government uses to tax oil and gas projects in Australia.

PRRT was introduced in the mid 1980s for new projects and replaced the existing crude oil excise and Commonwealth royalty systems that were in place at the time. The regime was expanded and significantly modified in the early 1990s. While the regime has undergone a number of structural modifications, many of the detailed provisions remain unaltered. In the meantime, the industry has gradually changed and grown from that which was typical at the time of the introduction of the regime. In addition, the intervening 20 years has provided taxpayers, administrators and policy setters with considerable hands-on experience with the way the system operates, while the number of taxpayers required to lodge returns under the regime has gradually risen.

PRRT is an economic tax with the following basic features:

- it is assessed on a project basis;
- liability to pay PRRT is on a producer/company;
- it is assessed at a rate of 40 per cent;
- is payable quarterly on an instalment basis;
- a liability is incurred when all allowable expenditures (including compounding) have been deducted from assessable receipts;
- assessable receipts include the amounts received from the sale of all petroleum (a 'marketable petroleum commodity');
- deductions include capital and operating costs that relate to the petroleum project, and are deductible in the year they are incurred. Deductible expenditures include those related to exploration, development, operating and closing down activities;
- expenditures which are non-deductible include financing costs, some indirect administration costs, income tax and cash bidding payments; and
- undeducted expenditures are compounded forward at a variety of rates depending on the nature of those expenditures and the time that they are incurred prior to the application for a production licence.

Petroleum Royalties

While the specific details of the various royalty regimes vary across jurisdictions in Australia, the basis features are as follows:

- royalty is levied on a licence area basis;
- liability to pay royalty is on the net wellhead value of production;
- it is levied at rates of between 10 and 12 ½ per cent of the wellhead value;
- limits often apply to deductions such that a minimum royalty liability must be paid in any single period (usually from the commencement of production); and
- costs incurred between the wellhead and the point of sale (ie post wellhead costs) are deducted from gross receipts to ascertain the wellhead value. Deductible costs can include the post wellhead depreciated value of capital equipment, an allowance for the cost of capital, operating expenses and crude oil and condensate excise (in some cases).

Crude Oil Excise

Crude oil excise is calculated as a percentage of the volume weighted average of realised f.o.b price (VOLWARE) made from a designated region. Crude oil and condensate is subject to excise in a manner such that higher percentage rates apply to higher levels of production or liftings from each prescribed production area.

The excise scales that apply to production from each prescribed production area are dependent on the date of discovery and/or the commencement of production.

In addition, the current excise provisions allow for the following:

- the exemption from excise of the first 4,767.3 megalitres or 30 million barrels of cumulative production from each petroleum field where excise applies; and
- the exemption from excise of all gas production, including liquefied petroleum gas, liquefied natural gas and commercial gas/ethane.

Proposed 'Flow Through Share' Model

General Eligibility

1. An exploration tax credit (ETC) would be allowed to Australian resident shareholders of Australian resource exploration companies, in respect of Australian exploration expenditure incurred by those companies. The eligibility would extend to all exploration expenditure incurred in all licence and permits areas in Australia, subject to the conditions outlined below.

Specific Provisions

2. All relevant terms are defined under current tax law, and would be adopted unchanged for the FTS model.
3. The industry model has been adapted from Australia's franking credit system, a central plank of Australia's company tax law which is widely understood in the community and has been well-honed legislatively over the past 20+ years. The industry believes that an ETC system can be built quite simply using the constructs of the franking system.
4. The ETC would be available to all shareholders on the register on the day the ETC was "declared" – which cannot happen until after exploration expenditure is actually incurred. Once the ETC is declared, shareholders can include the ETC in their tax returns.
5. The credit would be available to shareholders of all companies undertaking eligible exploration in Australia. This is consistent with access to the R&D concession, and to the franking system generally. The industry would not object if the government wished to make a statutory audit compulsory for ETC companies, to help ensure the veracity of their financial information.
6. The credit would be available at the company tax rate, currently 30 per cent. All taxpayers would be entitled to the credit based on this rate, regardless of their own tax rate – including super funds with a 15 per cent tax rate and individuals on low or nil tax rates. Taxpayers unable to use the credit against their tax liability would be entitled to a refund, on the same basis as franking credits are refundable.
7. The ETC system would be voluntary – exploration companies could retain their exploration deductions for their own future use if they wished, or could pass them on to shareholders immediately via the ETC system. The details could be specified in any fund raising prospectus.
8. There would be no time limit on the use of ETCs – just as the franking system has no time limits. However, companies which do not distribute their ETCs are likely to eventually use the exploration deductions themselves, as they begin to derive assessable income from mining and petroleum activities, and the ETCs will naturally dissipate at that point.
9. A company (or corporate group) would *not* be permitted to choose to pay tax itself and instead use its exploration expenditure to distribute ETCs to shareholders. That is, if the company has net taxable income after all expenses and prior year tax losses have been deducted, it would be *required* to use its own exploration expenditure to reduce its taxable income to \$nil. For example, if an exploration company still has taxable income of \$2m after using all its other deductions, it must

use at least \$2m of its own exploration deductions to reduce its Taxable Income to \$nil. That \$2m of exploration expenditure would thus not be available as an ETC. It could, however, pass on any remaining exploration deductions to shareholders via the ETC mechanism, if it wished to.

This device is necessary to ensure that the ETC mechanism is contained to appropriate explorers. Once a corporate group becomes tax paying, it will no longer have access to the ETC system and must use its exploration deductions itself. No special legislation is required to bring this about – a company must use all of its available deductions in calculating its taxable income, and thus any un-distributed exploration expenditure would automatically be deducted in the tax return process where positive taxable income is present.

10. The taxable income test would be considered from a corporate consolidated group perspective. Where companies have elected to be a consolidated group for tax purposes, the group as a whole must be in tax losses for any ETCs to be passed on to shareholders. **This effectively limits the ETC system to small explorers, where no company in the group is generating significant assessable income. This test alone should be sufficient to ensure that the concession is appropriately targeted at junior explorers.**

It may, however, be considered necessary to have a mechanism for limiting the amount of ETCs a company may pass on. One simple way of doing this would be to apply an annual cap on the amount of ETCs claimed per company (or corporate group), but it is important that the cap does not distort exploration decision-making by companies and is high enough to reflect the high cost of undertaking exploration in certain areas (particularly offshore). For example, *all* companies could be eligible to pass on credits but only for a defined amount of exploration expenditure incurred on a per annum basis. When combined with the rule that ETCs can only be passed on by companies and corporate groups with tax losses, this effectively automatically self-limits the ETC to small exploration companies: large companies would have taxable income, and thus be required to claim the exploration deductions themselves.

11. Companies would have flexibility in the timing of passing on the credit, using a franking-account-like mechanism. Any shareholder on the register at the company's declared record date for distribution of the ETC would receive it. Shareholders who sell out early (for example, short term IPO speculators) would not receive it because they would have sold their shares before the company incurs actual exploration expenditure, and it is more likely that long term shareholding would be encouraged.
12. In the case of new capital raisings in existing companies, to make it attractive for new investors to facilitate a successful fund raising, it may be necessary to restrict the ETC to the investors who are contributing the new funds. Therefore, it needs to be possible for a company to direct the ETCs to the new shareholders rather than all the existing shareholders, via the use of different share classes - as is the case for franking.
13. A number of well-tested Australian tax mechanisms would operate to ensure that there was no double deduction of the exploration expenditure either by the company, or for shareholder CGT purposes. These mechanisms are already part of the tax law for other purposes, so no new concepts are being proposed. For shareholders, the ETC would reduce their CGT cost base.
14. The ETC would be based on eligible exploration expenditure. Eligible exploration expenditure would be all exploration expenditure incurred in any area of Australia.

15. If a company distributes ETCs and it is later found that its expenditure does not meet the eligible exploration definitions, this should be dealt with at the *corporate* level rather than at the shareholder level. A legislative mechanism identical to the Franking Deficits Tax model could be adopted, including the penalty provisions.
16. All anti-avoidance provisions existing in the franking law would also apply to the ETC system – for example, the anti-streaming rules, and the 45-day rule. A simple amendment would ensure that these provisions were mirrored in the ETC provisions.
17. The ETC scheme would apply to all exploration expenditure incurred after **1 July 2009**. Existing and new companies making eligible expenditure after that date would be able to make ETC distributions if they met the other requirements outlined above, to new and existing shareholders.
18. A 25 - 75 per cent uplift in the credit, consistent with the R&D uplift obtained by Australian innovation companies, should be applicable to the ETC system. This would reflect the high front end risk, and significant long term future dividends payable to all Australians that flow from mineral exploration, which are comparable to those relating to R&D investment.
19. Further issues that may need to be considered would include the treatment of the regime for company and trust shareholders and the possible scope of the regime, however we consider a compelling case exists for the system to apply to all petroleum exploration in Australia. The various provisions outlined about will act to limit its application to junior and Australian companies without adequate income to offset exploration expenditure.