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Managing Director and Chief Executive Officer



30 March 2017

Committee Secretary
Senate Economics References Committee
Department of the Senate
Parliament House
CANBERRA ACT 2600

Dear Committee Secretary

Inquiry into Corporate Tax Avoidance

We refer to the Committee's resolution of 1 December 2016 to broaden the scope of the inquiry to include Australia's offshore oil and gas industry and the invitation to receive submissions on the treatment and/or payment of:

- i. royalties;*
- ii. the Petroleum Resource Rent Tax (PRRT);*
- iii. deductions; and*
- iv. other taxes*

by corporations involved in Australia's offshore oil and gas industry, including matters relating to the collection of these moneys by government.

Santos welcomes the opportunity to comment on these issues. As you are aware, Santos is an independent Australian listed company. The company has five core areas of focus which, with the exception of PNG LNG, are in Australia and subject to PRRT.

These projects require many billions of dollars more in uncommitted investments if they are going to contribute to the critical need for further gas to supply the East Coast market and Queensland LNG export commitments. The capital intensive nature and profitability of these projects is such that changes to PRRT can effect further investment decisions and the review must be cognisant of its potential impact on future gas supply. Billions have already been invested and billions more are in the process of being planned and committed on the basis of the current regime and fiscal stability is a prerequisite to sustain Australia's attractiveness as an investment destination. It is currently an important time in the cycle of exploration, feasibility, development and production where further investment and exploration needs to be encouraged and any adverse change to tax regimes would potentially act as a disincentive for companies. This is even more important given the current discussions with the Australian Government on the need to provide additional gas to the East Coast gas market.

You will also be aware of the review of PRRT being conducted by Mr Michael Callaghan AM. Santos made a submission to the review and this is attached for your information. The submission to the PRRT review covers the majority of issues raised by the expanded terms of reference on which we wish to comment. In addition to that submission we provide the following comments on matters relating to the integrity, administration and collection of PRRT by the Australian Taxation Office (ATO).

As a large corporate, Santos is subject to the ATO risk differentiation framework for a range of taxes including PRRT. Based on its risk review processes the ATO has considered the risks associated with PRRT compliance by Santos and rated the company as a key taxpayer. Santos projects have been subject to a number of PRRT reviews by the ATO including questionnaires and visits to our offices for discussions and information gathering. These have covered a number of projects and issues including starting base.

Santos personnel actively participate in the Australian Petroleum Production & Exploration Association (APPEA) fiscal committee which has met regularly over many years with ATO personnel engaged in the administration of PRRT matters. The meetings have spent a lot of time providing the ATO with an understanding of operations subject to PRRT and consulting on rulings, guidelines and proposed legislation. They have proved mutually beneficial to industry and the ATO in addressing our respective concerns. This has also included participation in the ATO Energy & Resources Working Group which includes PRRT issues and reports to a wide range of stakeholders.

In our view, these processes by the ATO provide assurance on the integrity of the administration of PRRT and compliance by taxpayers.

We will be pleased to discuss these matters with you further.

Yours sincerely

Kevin Gallagher
Managing Director and Chief Executive Officer

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3 February 2017

Mr Michael Callaghan AM
PRRT Review
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Mr Callaghan

Review of the Petroleum Resource Rent Tax

Santos welcomes the opportunity to comment on the Review of the Petroleum Resource Rent Tax. As stated in the Issues Note of 20 December 2016, the petroleum resource rent tax ("PRRT") was designed to capture economic rent, or amounts in excess of the returns needed to attract a commercial investment. Other forms of taxation on these projects could distort investment signals and reduce the attractiveness of more marginal projects, resulting in vital gas reserves being left in the ground.

As you are aware, Santos is an independent Australian listed company. The company has five core areas of focus which, with the exception of PNG LNG, are in Australia and subject to PRRT. Notwithstanding this focus, the company's investments are subject to the international competitiveness of the Australian petroleum industry and in particular the fiscal regime. Many of our joint venture projects are conducted with overseas parties with global portfolios within which Australian projects have to compete for investment capital. These projects rely on decisions by all joint venture participants to proceed and hence the additional exposure of Santos to global portfolios.

The projects also require many billions of dollars more in uncommitted investments if they are going to contribute to the critical need for further gas to supply the East Coast market and Queensland LNG export commitments. The capital intensive nature and profitability of these projects is such that changes to PRRT can effect further investment decisions and the review must be cognisant of its potential impact on future gas supply. Billions have already been invested and billions more are in the process of being planned and committed on the basis of the current regime and fiscal stability is a prerequisite to sustain Australia's attractiveness as an investment destination. This review is coming at an important time of the cycle where further investment and exploration needs to be encouraged and any adverse change to tax regimes would potentially act as a disincentive for companies.

Santos has participated in a number of offshore and onshore oil and gas projects during the period of operation of PRRT, from 1 July 1986 (see attachment). Based on our experience with petroleum projects in which Santos has an interest it is our view that PRRT has operated as intended and that therefore the existing design features are appropriate.

The majority of Santos offshore oil and gas projects have paid PRRT during their lives. The timing of payments has reflected where each project was in the cycle of exploration, feasibility, development and production, the nature of the development, economic conditions and exploration expenditure that has been transferred between projects. PRRT was extended to onshore projects from 1 July 2012. These projects have continued to be subject to payments of state government ad valorem royalty providing the traditional onshore return to the community.

Santos is pleased to provide the following comments in respect of the specific issues raised in the Issues Note.

The overall performance of the PRRT, excise and associated Commonwealth royalty arrangements and whether they are operating as intended

In Santos' view the PRRT regime has performed as originally intended. That is principally to measure the rent accruing from petroleum projects that, through the imposition of PRRT, is shared between the government and producers. In so doing, the impact of PRRT should not affect investment decisions in respect of oil and gas projects, as is the case with alternative imposts such as ad valorem royalty. In our view the first of the Review's terms of Reference - the need to provide an appropriate return to the community on Australia's finite oil and gas resources while supporting the development of those resources, including industry exploration, investment and growth - is a simple restatement of these original intentions.

The PRRT law as originally introduced has been amended in a number of respects. The principal changes together with the impact on the original operation of the PRRT regime are as follows:

- Reducing the rate of augmentation on general project expenditure incurred from 1 July 1990 by 10% points and allowing for the transfer of exploration expenditure between petroleum projects from 1 July 1990

In broad terms the reduction in the rate of augmentation of general project expenditure to the long term bond rate (LTBR) plus 5% was imposed to fund the transferability of exploration expenditure between projects. The reduction recognised the lower risk associated with general project expenditure, whilst the transferability of exploration expenditure recognised the high risk associated with recovering exploration expenditure. Enabling producers to recover exploration expenditure before paying PRRT is consistent with the Garnaut - Clunies Ross model of a resource rent tax.

The change in augmentation rate for post 30 June 1990 general expenditure resulted in a greater need to specify the order in which deductions were taken against revenue. Previously this was only relevant to the limited transferability of exploration expenditure incurred in the original blocks from which a production licence was issued.

In our view these changes do not adversely affect the original intentions of PRRT.

- Regulations to determine the assessable receipts from gas produced by an integrated gas project, in particular the residual price methodology (RPM) for valuing gas

Whilst the key RPM determinants of the return on capital and the split of rent between the upstream and downstream components of an integrated gas project have an impact on PRRT collections, the Regulations merely codified the requirements of the original legislation to determine the arm's length value of gas produced from an integrated gas project at the PRRT ring-fence.

Any scheme applying allowances of general application, such as the rates of augmentation and RPM parameters, will not measure the precise rent applicable to each petroleum project. However, it is considered that considerable benefits arise from such a common approach which outweigh any negative impact. For example, the simplicity and certainty provided to government and producers from defined measures.

- **Expanding assessable receipts to include tolling revenue**

The extension of assessable receipts to include tolling revenue was a pragmatic response to difficulties with the previous provisions, which denied a deduction for the capital costs of facilities used to toll non-project petroleum. Whilst the current provisions may look like providing asymmetrical positions in instances where projects paying a toll receive a PRRT deduction but the receipt of the toll is not subject to PRRT, the provisions should operate in this manner and in fact are likely to collect more PRRT revenue than under the previous arrangements denying deductions. We consider this change beneficial for PRRT receipts.

- **Extension of PRRT onshore, from 1 July 2012.**

The onshore PRRT does not deliver the important attribute of PRRT of not distorting investment decisions because of the continued application of state ad valorem royalties. The payment of underlying state government royalties limits the likelihood of PRRT liabilities arising. It is important that the tax regime does not deter the need to invest the many billion dollars of uncommitted future capital on gas developments required to maintain the supply of gas to the East Coast Australia market and Queensland LNG export commitments.

A frontier exploration incentive also applied to selected, high risk acreage released during the period 2004 - 2009, but has been discontinued.

More relevant to the overall performance of PRRT to date than legislative changes are changes over time to the petroleum industry and economic conditions generally. These include:

- Reduced discovery and production of oil in Australia
- Increased technical capacity to explore and produce gas in more technically demanding depths and conditions, remote from existing transportation, processing and export facilities
- Increased feasibility study requirements given the higher risk and scale of projects
- Longer lead times through the cycle of exploration, feasibility, development and production
- Expanding international markets for gas, in liquefied form (LNG)
- Higher capital investment costs
- Significant capital requirements and foreign earnings
- Ongoing oil price fluctuations
- Ongoing foreign exchange rate fluctuations

These factors all have an impact on PRRT collections through their impact on revenue, deductions, timing of income and expenditure and the rate of return from a project, without detracting from the intended operation of the PRRT system.

The reasons for the decline in petroleum taxation revenue including the impact of conditions in the industry and features of the tax regimes

The decline in PRRT revenue in recent years is a direct function of increased costs and reduced revenues together with a large number of projects being in the early production phase of the cycle of exploration, feasibility, development and production and with significant project life remaining in which to recover the investment costs.

The key feature of the PRRT regime is the measurement of rent and the entitlement of producers to recover the costs they contribute to a petroleum project. This augmentation is required to ensure that

PRRT is not triggered before the rate of return used to measure rent is achieved. As a result of longer time frames for the recovery of project costs, the deductions applicable to the augmentation of actual expenditure are greater than would otherwise be the case, thereby reducing tax collections.

PRRT collections from some petroleum producers are also affected by the transferability of exploration expenditure.

In our view these impacts are consistent with the features of the PRRT regime.

The appropriateness of the following design features:

The treatment of carry forward losses and the level and structure of uplift rates under the PRRT

Based on our comments above, in our view the treatment of carry forward losses (undeducted augmented expenditure) and the level and structure of uplift rates under the PRRT is appropriate.

The Issues Note Public Commentary on carry forward losses and uplift rates notes comments by The Australia's Future Tax System Review that the corporate bond rate is a useful proxy to compensate investors in the absence of a full loss offset.

In our submission, unless the risk returns used to measure the rent are used to uplift undeducted expenditure then investors will be paying PRRT before rent is earned. The risk of a less than full loss offset to which the Review referred is the same risk used to determine the rent. It relates to the project and not to a simple time value of money or bond rate reflecting a company's overall activities which may include non-PRRT activities or a range of PRRT projects at various stages of development and therefore risk.

The transferability of deduction for the PRRT

In our submission, the transferability of exploration expenditure is an integral feature of PRRT, reducing the risk of being unable to recover expenditure. It also provides appropriate recognition of the reduction in the rate of augmentation of general expenditure from 1 July 1990 as outline above. The transferability of exploration is a key feature of PRRT that must be retained as it provides a real incentive to undertake the high risk exploration activity necessary for the continued development of Australia's petroleum resources.

The importance of the transferability of exploration expenditure on investment decisions is illustrated by the common approach to making exploration investment decisions, which is the use of expected monetary valuation (EMV) analysis. The EMV methodology weights the discounted cash flows from a range of possible outcomes of exploration (including failure and various scales of success and development) to determine a risk weighted valuation. A positive EMV should enable a positive investment decision. The importance is that under this methodology, the full PRRT relief from exploration is available because it is achieved in all possible outcomes.

For example, assume the following three potential outcomes:

- (i) An exploration well costing \$50 million that is a failure
- (ii) A successful exploration well followed by appraisal and development and production from a base case. The discounted NPV (using the investment threshold discount rate) of future after tax cash flows excluding the initial exploration well is \$50 million
- (iii) A successful exploration well followed by appraisal, but with additional development cost and production to case (ii) as an upside case. The discounted NPV (using the investment threshold discount rate) of future after tax cash flows excluding the initial exploration well is \$150 million

The outcome is weighted 65% to an unsuccessful well, 25% to the base case and 10% to the upside case.

The exploration well gives rise to deductions for Income tax (\$15 million) and PRRT (\$14 million after income tax) and these benefits are received whichever case results. In this example the project has a positive EMV of \$6.5 million which suggests the well should be drilled. Without the PRRT transferability the after tax PRRT benefit from the case (i) failure of \$9.1 million would be lost and the EMV would be \$(2.6) million, suggesting that the well should not be drilled.

Outcome	Exploration pre tax	Income Tax	PRRT after tax	Exploration after tax	Other Cash flows	Total	Uncertainty	EMV	PRRT component of EMV
1	-50	15	14	-21	0	-21	0.65	-13.65	9.1
2	-50	15	14	-21	50	29	0.25	7.25	3.5
3	-50	15	14	-21	150	129	0.10	12.90	1.4
EMV								6.50	14.0

The PRRT transferability, together with the income tax deduction, plays an important part in encouraging critical exploration activity.

The test for and scope of deductible expenses under the PRRT

Some issues identified by the Policy Transition Group noted in the Issues Note have been resolved by amendment to the PRRT Act. Areas of expenditure currently disputed include whether expenditure is sufficiently directly related to a project to be deductible. In our view the uncertain or disputed areas of deductible expenses are of significantly less impact than other impacts on PRRT collections and do not adversely affect the integrity of PRRT. For example, the PRRT payable by projects with oil linked, US dollar revenues are affected much more by small changes to the Australian dollar equivalent price of oil than by any of the deductions subject to uncertainty.

The ATO has applied its established risk-differentiation framework to PRRT, as it does with income tax, to reinforce the integrity of the self-assessment system. In addition, regular discussions are held between industry and the ATO to address and clarify issues of concern to either party and to issue rulings and guidance material. These mechanisms are designed and operated to enable the community to have confidence in the administration of PRRT collections and in our view operate effectively.

The starting base arrangements in the extension of the PRRT in 2012

The starting base arrangements were an integral component of the package of measures to extend PRRT onshore without abolition of the existing state government ad valorem regimes. The imposition of a new tax to existing projects without appropriate transitional relief would have been unreasonable and should not be re-visited. Onshore petroleum producers have already had to deal with the imposition of a new tax and have still to contend with the adverse consequences of an ad valorem royalty on investment decisions and cash flows. It is critical that state government royalties and PRRT on onshore gas developments operating in a high cost environment do not deter the need to invest the many billion dollars of future capital on gas developments required to maintain the supply of gas to the East Coast Australia market and Queensland LNG export commitments.

Furthermore, as a transitional measure the starting base provisions will have no impact on new petroleum projects.

It is also noted that the Issues Note Public Commentary references to starting base are principally directed at MRRT rather than PRRT and at the market value choice of method, rather than the past cost or accounting value choices that were available to PRRT projects.

The order of deductions for the PRRT

It is accepted that the order of deductions is a difficult issue with no indication from the underlying theory of PRRT of the correct order. The current order that defers deductions for exploration expenditure can be justified on the basis that general expenditure should be given priority as it can only be recovered from the project on which it was incurred, whereas exploration expenditure is transferable to other projects.

As a practical matter the impact of augmentation on exploration expenditure is quite fact specific and may not be significant. Where a producer is able to transfer exploration expenditure there may be no or limited augmentation. For example, where the exploration expenditure is transferred in the year it is incurred there will be no augmentation. It is also relevant to note that the rules for transferring exploration between projects require transfers to be made to the petroleum project with the most recent licence. This requirement, in combination with the rule that limits bond rate augmentation to exploration expenditure incurred within 5 years of the production licence, increases the likelihood that transferrable exploration will fall outside the five year limit and will only be augmented at the GDP deflator.

As such, the likely impact of any change in order would be extremely difficult to forecast.

The application of the PRRT to gas projects and floating LNG

The Issues Note Public Commentary on Coverage states that Dr Diane Kraal from Monash University has noted that the PRRT regime was designed during a time when oil was more profitable than gas, and that the current tax system is not fit for purpose when it comes to ensuring a return for gas resources.

The PRRT model seeks to measure and tax the rent generated from a project. The fact that gas is less profitable than oil reflects the reduced rent generated from gas rather than the inappropriate nature of a resource rent tax approach to a community return. The resource rent tax approach overcomes the limitations of an output-based royalty. The community is also deriving a return as a consequence of firms risking significant amounts of capital in projects that deliver GDP from investment in construction, operations and export earnings. In addition, any assessment of the return available to the community should consider whether the remote, technical demanding location of resources, the capital required to be mobilised and long lead times for investment returns reduces the intrinsic value of the resources for secondary taxation purposes.

Much of the discussion on floating LNG in the report of the Economics and Standing Committee of the Western Australia Legislative Assembly on the Impact of FLNG on Western Australia referenced in the Issues Note Public Commentary is directed at tensions between the federal and state governments over revenue sharing. The report notes: *"FLNG projects represent a major benefit to the federal government. The lack of any onshore development means a much lower capital expenditure for the project. This results in higher profits, and, therefore, higher taxes, produced more quickly."* (paragraph 9.23). Arguably the lower capital costs and flexibility of floating LNG will facilitate investment in the project that may not otherwise occur and produce a significant flow of PRRT. Issues arise on the allocation of FLNG costs between the PRRT project and downstream operations but this is an apportionment issue that does not affect the efficacy of the PRRT regime.

The gas transfer pricing arrangements under the PRRT

The gas transfer price is a key determinant of PRRT payments in respect of integrated gas projects.

In relation to the comments of The Australia's Future Tax System Review set out in the Issues Note Public Commentary we note that the design of the gas transfer price regulations was the subject of detailed discussion and independent studies, in particular in respect of the rate of return and the split between the upstream and downstream phase. The capital allowance is not arbitrary but provides benefits of certainty and simplicity which are important, particularly in providing confidence on planning models. The original studies on the split between upstream and downstream reflects difficulties in splitting the return from integrated projects and we are not aware of an alternative basis of general application.

Dr Kraai has noted a lack of transparency in how the methodology is applied. In our view the operation of the gas transfer price methodology is set out in significant detail in the PRRT Regulations and explanatory statements. In addition, the ATO understands the significance of the gas transfer price to PRRT liabilities and is able to thoroughly review calculations.

Dr Kraai stated *"I am advocating for a GTPM review that would require liaison with the Australian Taxation Office and corporate tax units to prepare a comparison of the current myriad of GTPM interpretations as provided for in the PRRT Regulations."* This, together with a call for greater transparency, say nothing about the appropriateness of the gas transfer price methodology. The ATO and taxpayers do engage in a review of the application of the gas transfer price regulations.

Conclusion

As indicated, in our view PRRT operates as originally intended. The declining revenues are a function of changes to the industry and current commodity prices rather than changes or faults in the original design of PRRT. The stability of the PRRT system is critical to maintaining ongoing investment in the petroleum sector. The contribution of the petroleum industry to the Australian community should not be measured narrowly at any one point in time by reference to a single factor such as PRRT. It is critical to remember the conceptual strengths of PRRT, it must be assessed through the full exploration, feasibility, development and production cycle, and not merely in the early stages of large, long life projects facing a low price environment and its integrity should not be eroded in order to replace declining collections of other taxes.

We will be pleased to discuss these matters with you further.

Yours sincerely

Kevin Gallagher
Managing Director and Chief Executive Officer

**Attachment
Santos PRRT Projects**

Offshore:

Western Australia:

Skua

Jabiru Challis

Mutineer Exeter/Fletcher Finucane

Stag

East Spar

John Brookes

Spar

Reindeer

Victoria:

Kipper

Minerva

Casino/Henry

Patricia Baleen

Onshore:

Cooper Basin (SA & Qld)

GLNG (Qld)