Australian Government

The Treasury

Senate Standing Committee on Economics

Tax Laws Amendment (2011 Measures No.8) Bill 2011

Schedule 2 – Clarifying the taxing point for the Petroleum Resource Rent Tax

17 November 2011

Introduction

Schedule 2 of the Bill amends the definition of 'marketable petroleum commodity' (MPC) in the Petroleum Resource Rent Tax (PRRT) law to clarify the point at which such commodities are produced. The point at which MPCs are produced is central to the determination of the 'taxing point' and PRRT liability of a project.

The Government's decision to clarify the PRRT taxing point, in a way consistent with the established application of the PRRT law, was announced in the 2011-12 Budget.

Background

The PRRT is a 40 percent tax on the profits of offshore oil and gas projects (other than the North West Shelf). In years where project expenditure exceeds assessable receipts, the excess expenditure is carried forward and uplifted and can be used to offset profits made in later years of the project.

The 'taxing point' is normally where a MPC produced from the project becomes an 'excluded commodity', usually by being sold. The point defines the boundary of the PRRT project, and so is central to calculating project receipts, expenses and profits.

Marketable petroleum commodities are defined as any of the following ***products produced from petroleum***:

(a) stabilised crude oil;

(b) sales gas;

(c) condensate;

(d) liquefied petroleum gas; or

(e) ethane;

Sales gas, condensate and liquefied petroleum gas are further defined within the Act by reference to their chemical and/or physical properties.

Under the PRRT Act, a MPC becomes an excluded commodity at the point where the MPC:

(a) has been sold;

(b) after being produced, has been further processed or treated;

(c) has been moved away from the place of its production other than to adjacent storage; or

(d) has been moved away from adjacent storage.

Since its introduction in 1987, the PRRT has been applied on the basis that an MPC is not 'produced from petroleum' until the processes of the project have been concluded and the product is in its intended final form (usually for sale). For example, if a taxpayer's purpose is to process petroleum into sales gas for sale, it must be in its intended final form for that sale. An MPC cannot be ***produced*** at some point part-way through a process.

The Bill would amend the law to make this (previously implicit) purpose test explicit.

Policy Intent of the PRRT

The long-standing application of the PRRT, which the amendments in this Bill would affirm, is consistent with the original policy intent underpinning the PRRT, as reflected in both the explanatory memorandum and the second reading speech to the original PRRT Act.

Assessable receipts of a project will include amounts receivable from the sale, on an arm's length basis, of petroleum or of a marketable petroleum commodity...in the event that the marketable petroleum commodity is not sold at or immediately after the point of initial on-site storage (eg where stabilised crude oil is refined by the producer), the market value at that point will be treated as an assessable receipt of the project.

[Petroleum Resource Rent Tax Assessment Bill 1987 - Explanatory Memorandum]

In broad terms, a petroleum project incorporates the production licence area, and such treatment and other facilities outside the area as are integral to the production and initial on-site storage of marketable petroleum commodities such as stabilised crude oil, condensate and liquefied petroleum gas.

The boundaries of a petroleum project will not extend beyond the point at which a marketable petroleum commodity is initially stored after production – that is, the project boundaries will not extend to "downstream activities" such as refineries, facilities for the transport of marketable products from initial storage.

[Petroleum Resource Rent Tax Assessment Bill 1987 – Second Reading Speech]

In relation to this, on 8 May 1991, the Department of Primary Industry and Energy provided advice as to how the PRRT would apply to the Bass Strait project (see <u>Attachment A</u>). In particular, the advice noted that:

"The policy basis of the PRRT legislation is outlined in the Joint Statement on greenfields RRT released by the Treasurer and the Minister for Resources and Energy in June 1984. The Statement makes it clear that a project is to include the production licence area and any facilities and operations which are essential for the production and initial on-site storage of MPCs. The Minister for Resources, Alan Griffiths, has indicated that the relevant policy announced in the Joint Statement should continue to be the basis for administration.

MPCs are defined on a product basis in the Act to reflect the fundamental principle that the RRT is a resource tax and should not extend to downstream processes such as refineries and facilities for transporting marketable products. The definition also refers to products produced from petroleum. In the case of Bass Strait sales gas, the intention has always been that this would be regarded as being produced at the onshore facilities at Longford as no production occurs at the platform"

Moreover, following a review of the operation of the PRRT undertaken in 1992, in November 1992, the then Minister for Resources, the Hon Alan Griffiths MP, tabled the final Report to Parliament on the operation of the *Petroleum Resource Rent Tax 1987*, which again stated the intended operation of the PRRT in relation to the Bass Strait project:

No practical problems have thus far emerged in the administration of the existing arrangements. The definition of an MPC clearly specifies that an MPC is a product produced from petroleum. Sales gas is not produced from petroleum at the platform and, therefore, concerns that the ringfence could in certain circumstances be at the platform are not warranted. The ringfence for sales gas produced from the Bass Strait project is established after initial stabilisation at the Longford plant.

Esso Australia Resources Pty Ltd v The Commissioner of Taxation

The doubt that this Bill seeks to remove arises as a result of litigation brought by the partners in the Bass Strait project in *Esso Australia Resources Pty Ltd v The Commissioner of Taxation*.

The Bass Strait project was transitioned into the PRRT regime with effect from 1 July 1990 by the *Petroleum Resource Rent Tax Amendment Act 1991*. Upon becoming subject to the PRRT, the project no longer had to pay Commonwealth crude oil excise and royalties.

As noted in the Explanatory Memorandum to the related Bill, transitioning the Bass Strait to PRRT (together with allowing for the transfer of exploration expenditure) had an estimated cost to revenue of $305 million in 1990-91 and $450 million in 1991-92, primarily due to the resulting decline in crude oil excise collections, and, given the transition occurred during a period of relatively low oil prices, the profit-based nature of the PRRT.

Importantly, as part of the transition all expenditures incurred in relation to the Bass Strait project prior to 1 July 1990 (including the cost of platforms, pipelines and processing facilities) were expressly deemed not deductible under the PRRT law. This was on the basis that the project's establishment expenditures had long been recovered prior to the PRRT being applied to the project.

In *Esso Australia v The Commissioner of Taxation*, the Bass Strait partners essentially argued that the point at which an MPC comes into being should be determined in a purely mechanistic way, having regard only to a substance's chemical and physical properties, rather than taking account of the actual circumstances and objectives of the project as envisaged by the Act.

Such an interpretation would run counter to the PRRT's intended design as a profits tax. It would:

- in many cases, result in the taxing point occurring at a point earlier than that at which a marketable petroleum commodity is sold, distributed offsite, or ready for processing into another commercial product, requiring a derived market value to be used to determine assessable receipts rather than the actual consideration received, significantly increasing uncertainty and complexity for taxpayers; and

- artificially limit the scope of activities related to a project, reducing the expenditure which is deductible for PRRT purposes and exclude expenditure on the actual operations to treat, transport, produce and initially store marketable petroleum commodities.

As noted in the Explanatory Memorandum (2.24), the unique circumstances regarding the Bass Strait project's transition to the PRRT (that is the non-deductibility of pre-1 July 1990 project establishment expenditures) meant that it would unambiguously profit from an earlier taxing point. However, this is not necessarily the case for other projects. The impact of the narrow interpretation on other PRRT taxpayers would have been less certain, and potentially increased their tax liability. This is because for those projects having an earlier taxing point than the one intended could well reduce their allowable deductions by more than their assessable receipts.

In April 2011, the Federal Court affirmed the Government's preferred interpretation.

Application of Amendments

These amendments would apply from 1 July 1990. This is intended to put beyond doubt the long-established operation of the PRRT.

Although they would take effect at a time prior to their introduction, the amendments are not retrospective in the sense that they do not retrospectively alter the PRRT taxpayers’ rights and liabilities under the law. Rather the amendments simply confirm the rights and liabilities imposed by the current application of the PRRT, consistent with the policy intent, and the way the PRRT has operated for over twenty years.