



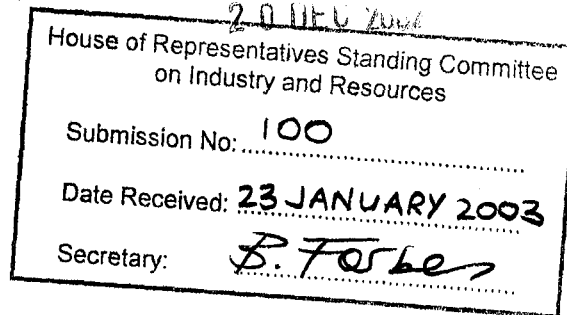
AUSTRALIAN PETROLEUM PRODUCTION & EXPLORATION
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12 December 2002

The Hon Geoff Prosser MP
Parliament House
CANBERRA ACT 2600

Dear Geoff



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Flow Through Share Proposal

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When I wrote to you on 25 October 2002 (in your role as Chairman of the House of Representatives Standing Committee on Industry and Resources Inquiry into Resources Exploration Impediments) about taxation issues relevant to exploration for oil and gas in Australia, I noted (among other things) that the Australian Petroleum Production & Exploration Association (APPEA) was recommending the adoption of a flow through share system as a means of providing an incentive to smaller oil and gas companies to undertake exploration in Australia. I said that:

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"APPEA would see such a scheme as being limited to exploration undertaken in Australia, with the introduction of credible, transparent and appropriate anti-avoidance measures."

Since this time, APPEA has carefully considered how such a system should be structured, with direct input from a range of junior exploration companies. As a result of that process, I am pleased to attach the details of a proposal which APPEA considers would be appropriate to deliver credible and transparent anti-avoidance measures, while at the same time providing a genuine incentive for companies to utilize the system. I hope that this proposal will be a positive input to the Standing Committee's deliberations on exploration impediments.

The issue of enhancing Australia's oil and gas exploration effort is, in APPEA's view, becoming critical. Given the time lags involved in acreage release processes and the approval of production licences, it is essential that positive signals are given to industry in the first half of 2003 so that the framework for companies bidding in the next round of acreage releases is more attractive. It is also important that we accelerate gas development proposals via the introduction of the other measures proposed by APPEA.

APPEA believes that it is important that decisions on taxation incentives be considered in the context of the 2003/2004 Commonwealth Budget. The Association recognizes that Australia faces a very tight fiscal situation. However,

we consider that adopting the Association's proposals in relation to PRRT and company tax (including flow through shares) will have minimal fiscal impact for several years because of the nature of the petroleum licencing system, as well as the quarantining of a number of the recommendations to new activities. It is important to send a positive signal to the industry in the Budget so that activity levels are stimulated as soon as possible.

In that context we hope that you may be able to give the Government the Committee's views on how taxation may address exploration impediments before next year's Budget processes are too far advanced.

APPEA would be happy to discuss its proposals further with the Committee.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Barry Jones', written in a cursive style.

Barry Jones
Executive Director

Improving Access to Capital : Design Features and Parameters of a Possible Flow Through Share Scheme

General Comments

The Australian Petroleum Production & Exploration Association (APPEA) is the national body that represents companies with activities in Australia's petroleum exploration and production industry. The proposal outlined below recognizes the difficulties faced by the Australian domestic exploration industry in raising capital for petroleum exploration in Australia. The proposal is aimed at developing and maintaining a healthy and dynamic domestic petroleum exploration industry to effectively explore Australia's vast area of prospective petroleum basins to assist in achieving our self sufficiency objectives. Such an outcome will also provide significant benefits for local businesses, encourage the development of new technologies and generate additional export opportunities.

Successful home grown exploration companies have historically been taken over by the larger international and domestic companies leaving few junior/mid sized explorers with production income to continue on-going exploration in Australia. These circumstances tend to restrict exploration to lower risk areas.

APPEA sees the proposal as forming an integral part of the broader capital raising activities of companies engaged in oil and gas operations in Australia. Importantly, it is not intended to apply to all such raisings, but rather, is designed to form a key component to boost targeted activities. Additionally, it also aids in addressing an inefficiency in the current tax laws whereby many companies are unable to 'unlock' exploration deductions and are therefore at a competitive disadvantage in capital raising activities. In effect, it is an attempt (at least in part) to 'level the playing field'.

A case can be made for the introduction of a system that provides a company with the ability to forgo any exploration deductions in favor of its shareholders. It is recognized however that in practice, some limitation may be required to ensure that the system has adequate integrity provisions and is targeted towards selected types of activities. Importantly, APPEA considers that companies should not become reliant in such an arrangement, but rather, it should act as a supplement to their normal commercial decision making processes.

The cost to Federal Government revenue, should it be targeted solely at oil and gas exploration operations, will be relatively modest and staggered over a number of years. In practice, such a scheme, if implemented from the 2003/04 financial year, would not materially impact on the revenue base for at least two years after this time due to the nature of petroleum exploration programs which are often spread over an extended period of time.

APPEA acknowledges that the conditions outlined below may somewhat limit the number of entities wishing to utilize the regime, however the Association is confident that it will attract a meaningful level of support. It will be an important building block in securing Australia's energy security into the future.

Key Design Features

Relinquishment Provisions

Upon the transfer of the eligible deductions to the eligible shareholders, the company immediately relinquishes the right to use the deduction against its own current or future income for income tax purposes.

Tax Rate

The eligible deduction to shareholders should be set at the prevailing company tax rate (currently 30 per cent) that is applicable at the time that the funds are expended. Such a treatment will ensure that an appropriate balance is struck between the tax write-off that can be used for companies with assessable income. Such a treatment would be non-distortionary.

Deduction Timing

An eligible shareholder should be able to utilize a flow through deduction in the same year that the funds are expended by the company. This provides a timing match between when a company would have technically been capable of claiming a deduction, if an income stream existed and had it chosen to utilize that approach. Such a treatment mitigates against any need to modify the applicable tax rate.

Eligible Shareholders

The arrangement should apply to designated capital raisings, which must be specified at the time that the funds are sought. In practice, this could include start-up capital contributions for a new entity or a special raising for an existing entity.

Eligible Exploration Activities

The existing definition that applies to petroleum exploration under section 40-730 of the Income Tax Assessment Act 1997 should apply. This provides a model that is consistent with the existing income tax laws. The types of activities covered by such a definition would therefore include:

- geological, geophysical and geochemical surveys;
- exploration drilling and appraisal drilling;
- feasibility studies to evaluate the economic feasibility of discoveries;
- obtaining information associated with the search for and evaluation of petroleum

The entirety of funds raised via the special raising must be expended on activities that fall within the above definition (ie it would be classified as a special designated raising). For example, brokerage and related fees could not be paid from the proceeds of the special capital raising - these would need to be covered via separate sources of funds (ie through internal company funds, a separate capital raising or another method). While this may cause some difficulty, it is seen as being a very important integrity measure that will provide a high level of transparency to the system. In addition, the proceeds must be totally expended in relation to areas under Australian jurisdiction (onshore or offshore).

Eligible Companies

A principle business test should be applied to ensure that the regime is focused towards genuine petroleum exploration and/or production companies. The company must continue to be engaged in such activities for the duration of the expenditure of the eligible funds. APPEA sees this as an important integrity measure. In addition, eligibility should be limited to Australian public registered companies that are domiciled in Australia (a company need not be listed on the Australian Stock Exchange).

Expenditure Time-Frame

The nominated exploration funds utilizing the flow through provisions must be expended within three (3) years of receipt. This will ensure that a positive signal is established to ensure that companies spend the funds on a timely basis. It will also act as a protection measure for contributing shareholders. However, a force majeure provision will need to be included to cover circumstances where a company is genuinely unable to expend funds, although this would be a strictly limited event via the application of a reasonable circumstances test.

Size of Eligibility Entities

APPEA can see no compelling reason to limit the scheme to a specific group of companies (other than using the criteria outlined above). By its very nature, it will be relatively more attractive to junior petroleum exploration companies that currently do not have the ability to utilize exploration deductions for company tax purposes. By avoiding the imposition of such a provision, it will mitigate against the need to set artificial criteria that may see companies move inside and outside the eligibility criteria guidelines on an ongoing basis. Such a situation would create considerable uncertainty. Furthermore, many large companies tend to fund activities from internal or debt sources – as such, they would not be in a position to utilize this system.

Related Party Transactions

Transactions between related parties would be excluded from the scope of the scheme - for example, a company would not be able to contract or engage the services of a related party to conduct an eligible exploration activity. Such expenditures would be deemed to be ineligible transactions for the purpose of deductions flowing to shareholders.

Eligible Acreage

Other than requiring funds to attach to exploration expenditure and exploration areas under Australian jurisdiction, APPEA sees no need to limit the regime to nominated acreage or areas. Companies will continue to focus their attention on areas and activities on the basis of the overriding risk reward framework. This should continue to be the preferred model.