

Tax insight



The current PRRT law is modified to extend to all onshore and offshore oil and gas projects. Taxpayers now have sufficient detail to assess the impact on their operations.

Extension of the Petroleum Resource Rent Tax

Introduction

On 26 August 2011, Treasury released for public comment the exposure draft legislation for the extension of the Petroleum Resource Rent Tax (PRRT).

The exposure draft legislation is based on, and generally consistent with, the recommendations provided by the Policy Transition Group (PTG) on 21 December 2010. As expected, the exposure draft legislation seeks to extend the current PRRT regime to oil and gas production on the North West Shelf Project and onshore oil and gas production, including coal seam gas (CSG) and oil shale from 1 July 2012.

However, despite incorporating many of the policies and recommendations of the PTG, some recommendations have not been implemented and there are issues that require further clarification.

Interested parties are invited to make submissions on the exposure draft legislation on or before 29 September 2011. The Government intends to introduce the legislation into Federal Parliament in the Spring sittings (ending 30 November 2011).

Changes at a glance	
New PRRT law	Current PRRT law
Applies to all Australian onshore and offshore oil and gas projects, including CSG and oil shale projects.	Covers only offshore petroleum projects as defined in the <i>Offshore Petroleum and Greenhouse Gas Storage Act 2006</i> .
Applies to the North West Shelf Project. Projects in the Joint Petroleum Development Area remain excluded.	Does not apply to the North West Shelf Project or projects in the Joint Petroleum Development Area.
The definition of petroleum is amended to include oil shale and exclude a taxable resource to which the Minerals Resource Rent Tax applies.	Petroleum has the same meaning as in the <i>Offshore Petroleum and Greenhouse Gas Storage Act 2006</i> .
<p>The Resources Minister retains the authority to combine projects, with this authority now extending to onshore projects.</p> <p>In deciding whether projects should be combined, the Minister will consider different factors depending on whether the projects are onshore or offshore.</p> <p>Offshore projects are assessed against the same criteria as those in the current law. For onshore projects, the degree of their downstream integration is considered; however their geological, geophysical and geochemical relationship is not relevant.</p>	<p>The Resources Minister may in certain circumstances, combine petroleum projects into a single project for PRRT purposes.</p> <p>Broadly, the combination is based on whether the following are sufficiently related:</p> <ul style="list-style-type: none"> (a) The respective operations, facilities and other things that comprise the petroleum project (b) The persons by whom or on whose behalf the operations, facilities and other things referred to in paragraph (a) are being carried on (c) The geological, geophysical, geochemical and other features of the projects
PRRT applies to all revenue generated from services and incidental products that were recovered, extracted or produced in carrying on a petroleum project.	PRRT does not apply to non-petroleum services and products that have been recovered, extracted or produced in carrying on a petroleum project.
Tolling receipts are assessable prior to the commencement of a petroleum project.	The law does not allow assessable tolling receipts to be derived prior to the commencement of a petroleum project.
<p>North West Shelf and onshore petroleum projects that were in existence at 2 May 2010 and transition to the PRRT on 1 July 2012, will receive additional deductible amounts. These will be either in the form of a starting base amount or by taking account of project expenditure incurred prior to 1 July 2012 via the look back approach.</p> <p>Transitioning projects can elect to apply either a market value or book value approach to determining the starting base amount.</p>	There is no equivalent under the current law.
Expenditures incurred in relation to operations and facilities that are carried on or provided for an environmental purpose (or related services) will be deductible as general or exploration expenditure.	Deductibility of environmental expenditure is not explicit in the current law.
Resource tax expenditures (for example State and Federal royalties and excise) are creditable (on a deduction equivalent basis) against assessable receipts.	Not applicable.
Payments made by way of compensation to native title holders, registered native title claimants and persons who hold rights (under a relevant Australian law) that relate to petroleum projects are deductible.	There are no specific references to native title deductions under the current law.

What projects will the PRRT apply to?

From 1 July 2012, the PRRT will be extended to apply to petroleum production (including CSG and oil shale) sourced from petroleum projects located onshore and in territorial waters, as well as from the North West Shelf Project area.

However, it will not apply to those resources which are subject to the Minerals Resource Rent Tax, for example, methane produced as an incidental product of coal mining.

The PRRT will not apply to the Joint Petroleum Development Area.

There is no de minimus test in the law, meaning all oil and gas operations will be impacted by the law, regardless of their scale of operations.

For gas to liquids projects transitioning into the PRRT, obtaining clarity on determining assessable receipts remains a key matter to be addressed.

What receipts will the PRRT apply to?

Generally, the PRRT is levied on the sale value or deemed sale value of marketable petroleum commodities. Marketable petroleum commodities include stabilised crude oil, sales gas, condensate, liquefied petroleum gas and ethane. This approach is retained under the draft legislation.

Taxable revenue will now also include 'assessable incidental production receipts', comprising all revenue generated from incidental products and services that were recovered, extracted or produced in carrying on a petroleum project. These amendments are expected to impact onshore CSG projects which may derive incidental income associated with the use or sale of treated water.

Assessable tolling receipts derived prior to the commencement of a petroleum project will now be taxable. The current law provides that this can only occur after commencement.

Projects transitioning to the PRRT will be taxed on assessable receipts derived from 1 July 2012. Where prepayments of income have been received prior to this date, the proportion that relates to activities after 1 July 2012 will also be taxed.

Following the Federal Court decision: *Esso Australia Resources Pty Ltd v FCT [2011] FCA 360*, the Government announced changes (in the 2011 Federal Budget) to the way in which the taxing point will be identified in the production chain. However, these changes have not been reflected in the exposure draft legislation.

The Esso case addressed the issue of identifying the point in the production chain where a marketable petroleum commodity is produced and therefore where the taxing point is located.

How will the value of assessable receipts be determined?

No change has been made to the manner in which the value of assessable receipts is to be determined.

The PTG recommended that:

- ▶ Taxpayers can elect to apply a royalty determination as the basis for determining PRRT revenue
- ▶ Taxpayers with onshore integrated gas to liquids projects have an option to use the residual price methodology (RPM) as a default methodology
- ▶ Transitioning liquefied natural gas (LNG) projects have access to a simplified RPM
- ▶ The existing RPM provisions within the PRRT be amended to provide for integrated gas-to-electricity projects

However, these recommendations have not been reflected in the PRRT exposure draft legislation.

PTG advice to amend the general PRRT deduction provisions was not incorporated in the exposure draft legislation.

Deductible expenditure

The PRRT exposure draft legislation has implemented the PTG's recommendations for a credit equivalent deduction to be available for the payment of other resource taxes (including State and Federal royalties and excises). Resource tax credits will be converted to a deduction equivalent by dividing the value of the expenditure by the PRRT rate (40%).

Native title payments under the *Native Title Act 1993* are to be treated as deductible.

It has now been clarified that a deduction will be available for expenditure to meet environmental regulatory requirements, which must be carried out throughout the life of a petroleum project. The PRRT exposure draft legislation is explicit that certain environmental expenditures are deductible, either as general project expenditure or exploration expenditure. However, there has been no express mention of the treatment of expenditure associated with the proposed carbon tax measures.

The PTG noted that the test for deductibility under the current PRRT law required expenditure to be directly related to project activities. They also noted that the application of this test had given rise to a number of disputes because it did not provide sufficient certainty as to whether or not expenditure was deductible. The PTG advised that the test for deductibility should be amended to one based on expenditure being 'necessarily incurred' in carrying on activities in relation to a petroleum project.

The PTG's advice to the Australian Government to amend the general PRRT deduction provisions was not reflected in the exposure draft legislation.

Deduction ordering	
Order of deduction	Description
Class 1 augmented bond rate general expenditure	General project expenditure incurred prior to 1 July 1990 and no more than five years before the production licence came into force, uplifted at the long term bond rate (LTBR) plus 15%.
Class 1 augmented bond rate exploration expenditure	Exploration expenditure incurred prior to 1 July 1990 and no more than five years before the production licence came into force, uplifted at the LTBR plus 15%.
Class 2 augmented bond rate general expenditure	General project expenditure incurred from 1 July 1990 and no more than five years before the date sufficient information was provided to support the production licence application, uplifted at the LTBR plus five per cent.
Class 1 gross domestic product(GDP) factor expenditure	General project expenditure incurred in any year and exploration expenditure incurred prior to 1 July 1990, that were both incurred more than five years before the date the production licence came into force, uplifted at the GDP factor rate.
Class 2 augmented bond rate exploration expenditure	Exploration expenditure incurred after 30 June 1990 and within five years before the date sufficient information was provided to support the production licence application, uplifted at the LTBR plus 15%.
Class 2 GDP factor expenditure	Exploration expenditure incurred after 30 June 1990 and more than five years before the date sufficient information was provided to support the production licence application, uplifted at the GDP factor rate.
Resource tax expenditure	Expenditure incurred under Australian law comprising either a royalty, an excise or an amount calculated by reference to the revenue, expenditure, value (at the wellhead) or profit made.
Acquired exploration expenditure	Expenditure on acquiring a project interest under the look back method that can be reasonably attributed to exploration activities.
Starting base expenditure	Expenditure resulting from deducting the starting base applicable to transitioning projects.
Closing-down expenditure	Expenditure incurred in closing-down a project. Closing-down expenditure in excess of assessable receipts is creditable.
Transferred in exploration expenditure	Exploration expenditure transferred from other projects held by the taxpayer, or from projects held by other companies in the same wholly owned group as the taxpayer.

For groups with more than one petroleum project, the ordering rules can result in excess resource tax expenditure remaining in one project, while another project is PRRT taxable. This is despite otherwise transferable exploration expenditure being incurred in the first project.

The starting base will only be deductible in the year after the production licence comes into force.

Transitioning projects - starting base

Those entities which held an interest in an exploration permit, retention lease or production licence at 2 May 2010 will be entitled to a starting base amount to take into account investments prior to 1 July 2012.

The starting base amount reduces a taxpayer's PRRT liability by allowing an immediate deduction for the value of petroleum projects existing at 2 May 2010 and certain expenditure incurred in the period from 2 May 2010 to 30 June 2012. The starting base amount will only be deductible if the asset to which the starting base applies is held from 2 May 2010 to 30 June 2012.

In addition, the starting base amount will only be deductible in the year after the production licence comes into force. The starting base is not transferable between projects.

The starting base is required to be calculated ignoring the presence of any private royalty arrangements in place at 1 May 2010. Care should be applied where private royalty arrangements are renegotiated on or after 2 May 2010. The explanatory memorandum outlines that if such an arrangement is renegotiated, the following may arise:

- ▶ If the restructure occurs before 1 July 2012 the starting base may be reduced
- ▶ If the restructure occurs after 1 July 2012, the project may be required to record an assessable property receipt

Starting base valuation approaches

In accordance with the PTG's recommendations, a taxpayer has a choice of three starting base valuation approaches:

1. **The book value approach** - This method uses the book values of starting base assets as recorded in the most recent audited financial report before 2 May 2010. It will also include interim capital expenditure incurred to 30 June 2012. Rights and interests that comprise the petroleum project interest itself (as well as information and goodwill) are excluded.

The starting base amount is augmented between the date of the auditor's report and 30 June 2012 at LTBR plus five per cent.

2. **The market value approach** - Under this method, the total starting base amount is the sum of the market value of all starting base assets as at 1 May 2010. It will also include any interim capital expenditure incurred in relation to the project interest to 30 June 2012. Starting base assets include rights and interests that comprise the petroleum project interest, information and goodwill.

The starting base amount is not augmented.

3. **The look-back approach** - Under this approach, the holder of the interest does not receive a starting base amount. Rather, they are able to take into account expenditure incurred from 1 July 2002, that would have been deductible had the PRRT applied at the time. This method is also the default approach if an interest holder fails to make a valid starting base choice.

While the various starting base valuation methodologies appear to provide taxpayers with a number of options, taxpayers will need to undertake a careful examination to ensure their circumstances satisfy the specific requirements in which the methods can be used.

Expenditure is augmented from the date it was incurred depending on the classification of the expenditure.

Under the look-back methodology, historical acquisition costs can be adopted. This method will apply where:

- ▶ The interest in the project was acquired between 1 July 2007 and 2 May 2010
- ▶ Where a company was (wholly) acquired between 1 July 2007 and 2 May 2010

It is necessary to apportion the acquisition costs between expenditure on exploration and other activities, in order to identify the component to be treated as exploration expenditure going forward (the 'acquired exploration expenditure').

As a general rule, entities have until 30 August 2013 to advise the Commissioner of Taxation of their choice of starting base valuation.

Shortcut for coal seam gas projects

The PRRT exposure draft legislation provides a short cut valuation method for CSG projects using the market valuation method. This method allows a 60cent/GJ value to be applied to 3P reserves to determine a project's starting base. This choice can only be made if:

- ▶ An interest in the project was acquired by any entity between 1 July 2007 and 2 May 2010; or
- ▶ Where a company that held an interest or another interest in the project, was wholly acquired by any entity between 1 July 2007 and 2 May 2011; and
- ▶ An independently certified reserves estimate was available on or before 2 May 2010

Taxpayers will need to evaluate the administrative benefits associated with using the various short cuts available, when determining which method provides the best outcome. They should also compare this to the opportunity cost of potentially obtaining a higher market valuation.

Acquisition of permits in the interim period 1 May 2010 to 30 June 2012

The PRRT exposure draft legislation does not address the starting base treatment for a purchaser of a petroleum project interest or exploration license which was in existence as at 2 May 2010. Rather, starting base treatment is only addressed where an interest is acquired by a taxpayer from 1 July 2012. Final law that does not provide the purchaser with access to a starting base in these circumstances would be inequitable.

There are practical difficulties with applying the combination rules to more complex holdings and this is particularly evident in the onshore industry.

Combining projects

The current rules governing the combining of petroleum projects, such that they are treated as one project for PRRT purposes, have been modified but remain largely intact. The set of factors to be considered in relation to offshore projects remains unchanged. For offshore projects, the Resources Minister must consider the following matters to determine whether the projects are sufficiently related to be treated as a single petroleum project:

- (a) **Onshore and offshore projects** - Includes the respective operations, facilities and other things that comprise, have comprised or will comprise the petroleum project in relation to the eligible production licence and any other petroleum projects or projects existing at the time, when the eligible production licence came into force.
- (b) **Onshore and offshore projects** - The persons by whom or on whose behalf the operations, facilities and other things referred to in paragraph (a) are being, have been or are proposed to be carried on or provided.
- (c) **Onshore projects only** - The extent (if any) that the respective operations, facilities and other things that are involved, have been involved or will be involved in any further processing or treating of any marketable petroleum commodity, produced in relation to the projects.
- (d) **Offshore projects only** - The geological, geophysical, geochemical and other features of the production licence areas in relation to the projects.

Other aspects of the combination certificate regime remain, including the requirement that the taxpayer (or multiple taxpayers) applying for a combination certificate, must have a 50% or greater entitlement in each interest being combined.

The PRRT exposure draft legislation does not allow taxpayers to form a PRRT consolidated group. This has implications for groups which hold interests in a single project (or combined project) through more than one company, as each company will be required to lodge a separate PRRT return.

The application for a combination of production licences existing at 1 July 2012 must be lodged within 90 days of that date.

North West Shelf Project

The exposure draft legislation extends the PRRT law to the North West Shelf Project and deems it a single project for PRRT purposes.

The North West Shelf Project cannot be combined with another project.

Transfer of project interests

The purchaser of a project interest after 1 July 2012 will inherit the appropriate share of carry forward undeducted starting base expenditure and other undeducted expenditure.

However, the ability to transfer a starting base amount on licences (other than production licences) acquired after 1 July 2012 is not clear due to the absence, at this time, of a mechanism in the draft law to achieve the transfer of such amounts.

Other matters

The PTG suggested (through advice rather than a formal recommendation) a number of additional changes to the existing PRRT regime, including:

- ▶ Aligning the definition of 'exploration' under the PRRT with the income tax definition
- ▶ Various administrative measures to provide for substituted accounting periods and an improved installment regime

These suggestions have not been incorporated into the exposure draft legislation.

Next steps

The Federal Government has invited submissions on the PRRT exposure draft legislation to be lodged on or before 29 September 2011. You may consider making a submission directly, or alternatively, we would be pleased to incorporate your views and concerns into our Ernst & Young submission.

In the meantime, taxpayers affected by these new measures should consider seeking advice to determine the impact of the PRRT exposure draft legislation on their projects and to prepare a transition and implementation strategy.

We are a long standing leader in the provision of PRRT advice and compliance services to the oil and gas industry and would be pleased to assist you in this process.

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