Petroleum Resource Rent Tax Review
Response to Treasury Consultation Paper

1 August 2017

Executive summary

BHP is one of the largest taxpayers in Australia, and the single largest payer of the Petroleum Resource Rent Tax (PRRT). Based on our experience in managing compliance with the PRRT and our decades in the Australian oil and gas sector, we believe it is clear that the PRRT is operating as intended.

- We do not believe there is a compelling case for design change to the PRRT. Reform that potentially destabilises long-standing taxation arrangements like the PRRT could significantly impact Australia's attractiveness to new investment, and therefore adversely impact the Australian community.

- The uplift rates should reflect project risk and associated risk-weighted hurdle rates and in addition be commensurate with the different types of expenditure incurred during the project cycle. Therefore, we do not agree that the purpose of the uplift rates is merely to maintain the value of deductible expenditure taking into account the risk that the project will not produce sufficient PRRT revenue against which deductible expenditure can be used.

- The current ordering rules ('based on a project first principle') are an intrinsic part of the PRRT framework and were intended to deliver a suitable level of economic rent on a project-by-project basis. Any change to reorder deductions should align with the intended outcome on uplift rates (i.e. the two areas are co-dependent).

- The transferability rules provide investors with an incentive to undertake exploration and maintain a portfolio of interests that move into production phase. This is a critical design feature of the PRRT and has been recognised as such in prior reviews of the PRRT regime. Therefore, the ability to transfer exploration expenditure to another PRRT-paying project must be retained.

- Any reform of the gas transfer pricing rules requires expanded engagement with industry. Each operation has unique geographical, logistical and engineering challenges that require a unique process design. The extent of integration of upstream and downstream operations is a commercial decision, and the existing Residual Pricing Method (RPM) framework remains an appropriate basis for determining the gas transfer price.

- The proposed measures to grandfather current projects under the existing PRRT rules are not without risk. We have identified scenarios where current projects (or contemplated projects where investment decisions may have already been made in respect of the development of existing exploration or retention leases) may be considered new projects under a new regime which, we believe, would be an unintended outcome.

- We support recommendations that improve the integrity, efficiency and administration of the PRRT. We believe this is the most appropriate and effective area for government to consider actions with respect to PRRT; such actions, if well implemented, would enhance the regime without detracting from its core design principles or placing future investment at risk.

Introduction

We welcome the Australian Government's ongoing consultation with industry and the community on this issue.

As the single largest payer of the PRRT, BHP is pleased to respond to the consultation paper released by Treasury on 30 June 2017: "Options to address the design issues identified in the Petroleum Resources Rent Tax Review" ('Consultation Paper'). This response builds on the submission we provided to the Callaghan review[1].

Simultaneously, we have made submissions and provided responses to the Senate Economics References Committee's inquiry into Corporate Tax Avoidance, and appeared at a hearing held by this Committee (focussed on the PRRT) in Perth on Friday 28 April 2017.

This submission responds to aspects of the design recommendations put forward in Part A of the Consultation Paper (the design of the PRRT) as well as the additional recommendations in Part B of that document (the integrity and administration of the PRRT). The Consultation Paper (expressly) did not consider alternative forms of taxation as a replacement to the PRRT. In our view, this is a positive decision.

In our submission to the Callaghan review, we stated that changes to current fiscal settings must be carefully evaluated in view of ensuring the competitiveness of the oil and gas industry in Australia. At the outset of this review, the Treasurer's statement of purpose for the PRRT was stated – that is to:

> ***"…ensure that the PRRT provides an equitable return to the Australian community from the recovery of petroleum resources without discouraging investment in exploration and development that is vital to the industry".*** (Media Release, 30 November 2016)

BHP endorsed the Treasurer's position as expressed in our submission to the Callaghan review. As a multi-commodity global resources company, BHP recognises that capital will flow to investment opportunities in resources that offer an appropriate balance between risk and return. The PRRT regime is a uniquely controllable lever for Government to manage the level of risk and return in a sector characterised by volatile pricing and substantial capital investment requirements.

Any design changes to the PRRT could have a direct and lasting impact on future investment.

In an environment of increasing costs and regulatory burden, the current regime has helped to attract capital investment to develop Australia's oil and gas industry. This investment has in turn benefitted, and in our view provided an appropriate return to, the community. For example, as set out in our submission to the Callaghan review, our company has paid more than A$11.2 billion in PRRT and royalties/excise since 2000. In the past five years, our Australian Petroleum Assets alone have contributed a further A$5.7 billion in company income tax, resulting in an effective tax and royalty rate of 55-58%. The benefits of a profits based resource tax that remains sensitive to movements in price and cost are significant – and the PRRT allows the community to equitably share in the benefit of investment in profitable projects over time (including during peak cycles).

In order to retain and attract new investment, Australia must offer a competitive tax system that is based on the principles of simplicity, stability, sustainability, transparency and fairness. The PRRT as it stands meets these design principles and has done since its inception in the 1980's.

Previous reform has focussed on expanding the 'scope' of the PRRT to existing and onshore projects to improve the incentive for exploration activity, rather than making changes that increased the tax impost on petroleum exploration and development activities. It is this stability of the PRRT regime that has provided investors with sufficient certainty to support their ongoing investment in the Australian oil and gas industry. As expressed in our submission to the Callaghan review, BHP does not consider that a compelling case exists to change the design of the PRRT regime.

[1] Review into the operation of he Petroleum Resource Rent Tax (PRRT), crude oil excise, and associated commonwealth royalties led by Michael Callaghan AM as released publicly on 28 April 2017 by Hon Scott Morrison MP.

Our response to the recommendations

BHP believes that the design of the PRRT should remain unchanged in order to avoid unintentional and lasting consequences impacting the Australian oil and gas industry.

The stability of the PRRT has been a positive influence on large scale investment in the Australian oil and gas industry. Within our own company, there is fierce competition for capital globally. Any increase in projected tax outlays under the PRRT, which are implied in some of the changes discussed in the Consultation Paper, will significantly challenge the attractiveness of investing in projects like the Scarborough natural gas field offshore Western Australia. BHP provided detail on the Scarborough Project in our submission to the Callaghan review.

BHP does not support the recommendations proposed to change the design of the PRRT.

Part A recommendations

We provide below our view on the following key recommendations of the Consultation Paper:

1. Uplift rates applied to deductible expenditure;
2. Ordering of deductible expenditure;
3. Transferability of eligible expenditure; and
4. The gas transfer pricing rules.

We believe that any step taken to reform the design of the PRRT creates the risk of inadvertent impacts on both industry and the community.

Our feedback in respect of the Part A recommendations should be considered in view of the interdependencies contained in the PRRT's design. Further, BHP would support a continuation of Treasury's current consultation process.

Separately, it is our view that the gas transfer pricing provisions should be considered as part of an extended review process. Further consultation is critical to ensure that any reform carefully contemplates the changing commercial dynamics of integrated LNG projects in Australia to ensure such reform does not impact ongoing and new investment decisions. As Treasury would be aware, there were complexities involved in developing and implementing the current gas transfer pricing provisions. This same complexity exists when assessing the potential impact of changes to the provisions in the hope of short term revenue gains at the expense of future investment.

Changes to apply to new projects only

The proposed Part A changes are intended to apply only to new projects from a date to be specified.

The Callaghan review proposed that the definition of new projects make reference to the statutory meaning in Part IV of the *Petroleum Resource Rent Tax Assessment Act 1987* (‘PRRTAA’). Section 19 of the PRRTAA defines a petroleum project as:

> 19 Petroleum project
>
> (1) Subject to subsection (1A) and (1B), for the purposes of this Act, where a production licence is in force and is not specified in a project combination certificate that is in force, there shall be taken to be a petroleum project in relation to the production licence.

Treasury has indicated that any changes to the PRRT regime are intended to be prospective in application. In order to achieve this, it has been proposed that the PRRTAA (in its current form) will continue to apply (as is) to projects with a production licence in force as at the effective date. BHP has identified scenarios that may arise where the intended outcome is not achieved. For example, if either:

(a) new production licences are issued in respect of a pre-existing exploration or retention licence (where an investment decision has already been made); or

(b) projects are issued with a combination certificate after the effective date that transitions existing projects into a ‘new regime’,

the object of prospective application will not be achieved. Instead, the effect of the proposed change would, in fact, be retrospective.

As noted in our submission to the Callaghan review (and as stated by other industry participants), if there are to be any changes, these changes must be applied prospectively to wholly new projects only. Impacting current projects and/or investment decisions will undermine investor certainty in Australia.

The Callaghan report further concluded that any significant increase in the tax on petroleum projects may substantially heighten the fiscal risk associated with investing in Australia, and consequently, deter future investment. The Callaghan report identified that this risk would be exacerbated by any change impacting a current project, and to quote:

> **“In considering the extent and timing of any changes to the PRRT, however, allowance has to be made for the very large recent investment in the Australian petroleum sector on the basis of long-standing taxation arrangements. Major changes to the PRRT that significantly increase the PRRT paid on existing projects could have adverse implications for Australia’s reputation as a stable investment destination.”** (Callaghan report, p. 14)

Any significant reform to the PRRT regime, to the extent it impacts current projects, would represent a departure from arrangements under which investment decisions have been made to date. This could undermine confidence and damage Australia’s reputation for low sovereign risk. Given the nature of the large-scale, long-term gas projects in Australia, stability in the tax arrangements remains critical to securing globally mobile capital.

The adoption of the proposed (new) project definition could place at risk investment decisions being made based on the current PRRT regime. Accordingly, we believe Treasury should carefully review this and we encourage the Government to act quickly to dispel any risk of retrospective change.

In the United Kingdom, changes made to the petroleum sector’s fiscal settings corresponded with a significant decline in exploration and development activity.

We believe that Treasury should recognise that any change which has the potential to adversely impact future investment may also adversely impact the community through, for example, less jobs being created, less taxes & royalties being paid and less support of local suppliers.

BHP does not consider the design changes put forward as being inconsequential for existing projects. We have considered these changes in further detail below.

Proposed changes to the uplift on deductible expenditure

The view has been expressed that the policy rationale behind the 'rate' of uplifts was to value the risk of not being able to utilise carry forward expenditure against PRRT revenue. The Callaghan report concluded that:

> **"…a PRRT design that sets uplift rates on the basis of investors' risk-weighted hurdle rates is likely to underestimate the levels of economic rent and therefore collect lower levels of PRRT. In contrast, uplifting PRRT losses at a rate commensurate with the risk of unutilised PRRT deductions would further tax neutrality and tax revenue objectives."** (Callaghan report, p. 72)

BHP appreciates there are competing views in relation to the impacts of changing the uplift rate. However, investment decisions are made based on a calculated assessment of project risk – that is; an investment will not be made unless it provides an appropriate rate of return to the investor for the risk borne in developing a petroleum project.

The current differentiation in the uplift mechanism distinguishes between different types of expenditure commensurate with the level of risk attributed to the stages of a petroleum project life cycle. The Federal Government's 1990 *Review into Petroleum Production Taxation* ('1990 Review') established that the threshold (uplift) rates should be set at a level which recognises an appropriate premium, as adjusted for the risk that specific costs may not be recoverable.

This 1990 review resulted in legislative arrangements that provide a balance to both the project risk premium as well as the risk of losing deductions. This past approach would suggest that there is a basis for differentiating between 'exploration' risk and 'development' risk – and therefore, provide support for differentiation in the rates.

In 1992, the Government commissioned a post implementation review to understand if the 1990 reforms had met their objectives. The final report[2] commented that the carry forward rate represented a premium on outlays commensurate with the risk that the investment may never be recovered. The report went on to explain that the differentiation between exploration and general expenditures was intended to recognise the relative risk characteristics of the different stages of a petroleum project. Industry recognises that one of the virtues of the PRRT is its recognition of risk; where it should not act as a barrier to the development of marginal resources.

In particular, BHP does not agree with any proposals to change the existing uplift rate for general expenditure deductions. We note this uplift rate was significantly reduced previously as part of the 1990-91 Federal Budget as a trade-off for the transferability of exploration costs – hence also providing a strong example demonstrating the integrated nature of the PRRT measures. The challenges and high risk nature of petroleum projects in Australia, particularly new exploration, together with the fact that general expenditure deductions cannot be transferred to other projects, supports the current uplift rate for general expenditure deductions. Accordingly, BHP supports the retention of the current uplift rate for general expenditure deductions.

Of the three options proposed in the current set of recommendations, BHP has significant concerns that a dual regime could be implemented in Australia. We believe that approach introduces a risk of distortionary outcomes between existing and future projects which could be significant. It also adds further complexity to the PRRT regime which counteracts efforts to simplify the regime.

The uplift mechanism interacts with other parts of the PRRT including the transferability rules for which further recommendations have been made. These have been considered in further detail below.

Proposed changes to the ordering of deductible expenditure

The PRRTAA prescribes the order in which eligible deductible expenditure is applied in ascertaining the PRRT liability. The ordering provisions currently apply on a 'project first' basis, where general expenditure is deducted prior to transferred exploration expenditure.

This approach is consistent with the distinction drawn in the PRRT between exploration and general expenditure, an area in respect of which we have provided comment earlier in this submission.

Recommendations made to reorder deductions such that expenditure attracting a higher uplift rate is deducted first becomes moot if changes are made to equalise the rate of uplift across all categories of expenditure.

[2] Report on he Operation of the Petroleum Resource Rent Tax Assessment Act 1987 – November 1992

Notwithstanding, BHP is of the view that no change should be made to the current ordering rules because they are operating as intended.

Proposed changes to the transferability of expenditure

The ability to apply losses from unsuccessful exploration projects against the revenues generated by successful projects is a principal mechanism of the PRRT, and an incentive for future investment decisions.

Under the current law, companies can carry forward exploration losses and later deduct them against PRRT paying projects.

In our view, this provides an important incentive for companies to undertake high commercial risk exploration activity. A cornerstone feature of the PRRT is its recognition of the relationship between incentivising exploration activity and the objective of developing new projects.

Accordingly, we welcome the fact that, consistent with the Callaghan report, the options put forward in the Consultation Paper do not advocate for the removal of the wider deductibility / transferability provisions. Rather, the options put forward suggest changes be made to achieve a level of consistency in the outcomes obtained by different taxpayers. However, we are concerned that the "Questions for consultation" go beyond this and ask whether transferability should remain part of the PRRT. As noted above, we strongly support retention of the wider deductibility / transferability mechanism as it is key to supporting future exploration. Over the last decade, exploration activity in the Australian oil and gas industry has declined. Therefore, it is critically important at this time that the PRRT regime continues to support future exploration activity.

Treasury has proposed options that modify the impact of uplift rates that apply at either the time of transfer and/or when the exploration expenditure becomes deductible against future receipts.

Exploration is the lifeline of the oil and gas industry, and it is for this reason that we do not support changes that constrain or distort the incentive for companies to undertake exploration activity in Australia. BHP is of the view that no change should be made that impacts the operation of the current transferability rules.

Further, we also consider that any exploration expenditure incurred in respect of new projects (if changes were enacted) should remain available to be applied against current PRRT projects. We do not consider there are integrity concerns that would support removing or curtailing the transfer of exploration expenditure incurred in relation to a future project, to a pre-existing one that is PRRT paying. Otherwise, if transferability is precluded in these circumstances, a key feature of the PRRT regime which supports future exploration activity by adopting a portfolio approach in relation to exploration expenditure, would be significantly curtailed.

Review of the gas transfer pricing rules

The gas transfer pricing rules contained in the *Petroleum Resource Rent Tax Assessment Regulations 2015* ('the Regulations') were implemented to price the gas used in the liquefaction process where there is no arm's length sale between extraction and liquefaction (at the first point where a marketable petroleum commodity exists).

The expansion of the Australian oil and gas industry has required ongoing updates to the PRRT regime to maintain its relevance in a business environment – and BHP supports Treasury's focus on this.

Consultation between Government and industry in developing what became the residual pricing methodology ('RPM') under the gas transfer pricing rules was protracted, albeit as a matter of necessity due to the complex commercial nature of projects and striking the appropriate balance between upstream and downstream petroleum activities.

BHP remains of the view that the current rules achieve their intended purposes and importantly, do not inappropriately tax value generated from the downstream activities of projects.

However, to ensure that the gas transfer pricing rules are thoroughly and carefully considered BHP strongly advocates that the rules be reviewed under a separate, specific review process that recognises the extensive past investment in developing the current law.

Part B recommendations

The recommendations provided at Part B are intended to improve the integrity, efficiency and administration of the PRRT, with application to both existing and new projects. BHP endorses those recommendations which are of direct relevance to the company as these are designed to improve the integrity of the tax regime.

Reference	Recommendation	Issues identified
2	Prohibit new onshore projects from combining with onshore projects that have a starting base.	We are not directly impacted by this compliance recommendation.
4	Recognition of partial closing down expenditure as a legitimate general project expense.	We endorse this recommendation on the basis that the timing at which rehabilitation activities are undertaken should not be determinative to the PRRT outcome. The current general expenditure rules discriminate between progressive versus end of production closure activity which is inconsistent with industry practice and can therefore result in anomalous and unintended outcomes.
5	PRRT taxpayers to lodge annual returns after they start holding an interest in an exploration permit, retention lease or production lease.	We endorse this recommendation on the basis that it stands to provide greater transparency to the ATO/Treasury on the value of carry forward future PRRT deductions from the time a taxpayer starts to hold an exploration permit. However, to provide certainty (to both the ATO and taxpayers), which is particularly relevant in these circumstances given the long-lead time before some projects become PRRT paying, we recommend that there be a time limit under which returns remain 'open' to challenge. Treasury is asked to provide further clarification as regards the approach to administration of this recommendation. That is, the recommendation may impose an additional compliance burden on companies (particularly where multiple exploration or retention leases are held before a project combination certificate is given). For example, Treasury could consider a simplified disclosure regime where company-wide disclosures are made in respect of pre-production licence projects not deriving assessable receipts.
6	Provide the Commissioner of Taxation with power to treat a new project as a continuation of an earlier project.	We endorse this recommendation on the basis that it serves to fix a known anomaly where licence holders lose deductions if a production licence reverts to a retention lease.
7	Provide the Commissioner of Taxation with the discretion to recognise more than one project from a production licence area where there are genuinely separate and independent petroleum operations in the licence area.	We endorse this recommendation on the basis that it serves to ensure the legislation correctly recognises receipts/expenditure referable to multiple projects on the same licence area. Treasury is asked to provide further clarification as regards the approach to administration of this recommendation.
8	Extend to offshore projects the option of having all interests held within a group to be reported as a single PRRT return.	We endorse this recommendation.

Reference	Recommendation	Issues identified
9	Provide taxpayers the ability to adopt a substituted accounting period.	We are not directly impacted by this compliance recommendation. We are, however, party to joint venture arrangements in the Australian oil and gas industry. We note that the current 30-June compliance date achieves some alignment between the PRRT compliance processes of operators/participants. Consequently, if this change is implemented, we note that where there are parties in a joint venture who could potentially have different filing dates, additional compliance time/costs may arise in managing separate filing deadlines for annual returns. Therefore, further consideration is required regarding how this measure would apply in practice. For example, should additional time be given in these circumstances to companies to prepare their PRRT returns in view of the complexity of different filing dates and competing tax reporting commitments (e.g. income tax filings)?
10	Provide choice of functional currency to taxpayers operating with a Multiple Entry Consolidated (MEC) group.	We are not directly impacted by this compliance recommendation.
11	Provide the Commissioner the ability to administratively exempt projects from PRRT obligations.	We endorse this recommendation. Treasury is asked to provide further clarification as regards the approach to administration of this recommendation.
12	Make PRRT anti-avoidance rules consistent with those applying to income tax.	We endorse this recommendation.