

Santos Ltd
ABN 80 007 550 923
Santos Centre
60 Flinders Street
Adelaide South Australia 5000
GPO Box 2455
Adelaide South Australia 5001
Telephone: 61 8 8116 5000
Facsimile: 61 8 8116 5050
www.santos.com



The Manager, Large Corporate Unit
Corporate and International Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

Email: prrt@treasury.gov.au

28 July 2017

Dear Sir / Madam

Submission to the Petroleum Resource Rent Tax Review Consultation Paper

We welcome the opportunity to provide comments to Treasury on the Consultation Paper, "Options to address the design issues identified in the Petroleum Resource Rent Tax Review", dated 30 June 2017 ("the Consultation Paper").

We previously provided comments on the Review of the Petroleum Resource Rent Tax Issues Note of 20 December 2016 and our statements below should be read in conjunction with these comments.

Background

Santos is an independent Australian listed company with 5 core long-life assets: the Cooper Basin, Gladstone LNG, Papua New Guinea, Northern Australia and Western Australia. All of these assets are in Australia and subject to PRRT, with the exception of Papua New Guinea.

Many of Santos' joint venture projects are conducted with large overseas entities with international portfolios. The significant scale of these projects requires technology and investment of these large multinationals. Decisions by all joint venture participants are required to proceed with projects and hence Santos is exposed to changes in the international environment and competitiveness of Australia as an investment opportunity.

Impact of PRRT

Since the introduction of the PRRT regime on 1 July 1986, Santos has participated in a number of offshore and onshore oil and gas projects. In our experience, PRRT has operated as intended and

the existing design features are appropriate to encourage investment in Australia's oil and gas resources for the community and also provide an appropriate return to the community.

The majority of Santos' offshore 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.

Since the PRRT was extended to onshore projects on 1 July 2012, Santos' onshore projects have continued to be subject to payments of state government ad valorem royalty providing the traditional onshore return to the community.

Industry challenges

The oil and gas industry is currently experiencing particularly tough times with weak demand and low prices that is curtailing investment in future supply. It is a difficult and volatile environment in which to make strategic decisions and plan for the future.

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 companies are not disincentivised in finding and bringing new resources and supply to the Australian market.

Santos' has already invested billions of dollars in its projects on the basis of the current PRRT regime and billions more are needed in uncommitted investments if they are going to contribute to the critical need for further gas to supply the Australian market.

The capital intensive nature and profitability of these projects is such that changes to PRRT can affect investment decisions and any adverse changes will potentially act as a disincentive for companies to invest. Santos experienced firsthand the adverse uncertainty and delay in investment decisions created by the fiscal changes at the time of the proposed Resource Super Profits Tax and subsequent extension of PRRT to onshore projects.

Santos is pleased the Callaghan Report recognised the importance of fiscal stability and concluded that *"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"*. This is particularly important given the unprecedented scale of investments made by the industry in recent times which will require many years to repay.

Santos is pleased to provide the following comments in respect of the specific issues raised in the Treasury Consultation Paper.

General comments

Any options to address the design of the PRRT regime identified in the Callaghan Report should take into account the following considerations:

1. Policy intent of the PRRT regime

The PRRT regime is a profits based tax that is designed to ensure that the Australian community receives an appropriate return from the development of its resources while providing companies with an incentive to explore and develop those resources. Companies are encouraged to invest through the allowance of a rate of return commensurate with the risk involved in investing in exploration and development. The PRRT system achieves this by ensuring that PRRT is not payable until the rate of return used to measure the rent is

achieved. Any changes to the PRRT system should be viewed with this policy intent in mind.

2. Economic condition of the industry

PRRT revenues have declined in recent years as a result of the economic downturn in the industry, the oil price and the early position of many major projects in the cycle of exploration, development and production, and not as a consequence of deficiencies in the design of the PRRT.

The oil and gas industry is currently experiencing particularly difficult times. In recent years, companies have made significant capital investments in resource development, which has been followed by an unexpected collapse in the oil price. Revenue from these major investments is beginning to be generated however they will take many years to repay. The sustained low prices are having a major impact on the profitability of PRRT projects.

3. Integrated nature of the PRRT features

The PRRT has a number of design features which must be viewed together when considering any reforms to the system.

The Callaghan Report noted that *"in assessing particular PRRT design features to judge whether the PRRT is operating as intended, those features need to be balanced against how they interact with other elements of the PRRT and in the context of how the tax is working as a whole."* The Consultation Paper also recognises that *"all options need to be considered as a package in order to ascertain the interactions between changes to different elements of the PRRT..."*

In light of the above observations, our comments below are general views on the consultation questions. It is difficult to provide separate comments on each question as each aspect of the PRRT system cannot be considered in isolation and changes to one feature will impact changes to another feature.

Uplift Rates

In our opinion, the current level and structure of the uplift rates for carry forward losses (undeducted augmented expenditure) is appropriate.

The key feature of the PRRT system is the measurement of the overall project rent and the entitlement of producers to recover the costs they contribute to a petroleum project. This provides investors with an incentive to explore and develop Australia's oil and gas resources. The uplift rates measure the risk adjusted rent or return that producers need to generate to invest in a project and ensure that PRRT is not payable until the rate of return used to measure the rent is achieved.

The Consultation Paper identifies a number of uplift options for reform of the PRRT. As noted above, the uplift rates are designed to ensure that the risk of a project is measured and a rate of return is received before PRRT is payable. The current uplift rates achieve this by reflecting the level of risk of each type of expenditure and maintain the policy intent of the legislation.

Any reduction in the rate to reflect the risk of losing deductions is not appropriate. In addition, capping the number of years for which an uplift rate applies or introducing an investment allowance provision does not acknowledge the key feature of the legislation.

Any changes to the uplift rates will need to consider the impact and potential change to the ordering of deductions and the transferability of expenditure. For example, when provisions were introduced to allow the transferability of exploration expenditure between projects, changes were also made to reduce the rate of augmentation on general project expenditure incurred from 1 July 1990 by 10% points to the long term bond rate plus 5%. 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.

It is also important to note that the impact of augmentation on exploration expenditure is quite fact specific and might not be significant. Where a producer is able to transfer exploration expenditure there may be no or limited augmentation. For example, there will be no augmentation where the exploration expenditure is transferred in the year it is incurred.

It is also relevant to note that one of the rules for transferring exploration between projects requires exploration 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.

Resource tax expenditure was introduced as an item of deductible expenditure when PRRT was extended onshore to ensure that PRRT projects are not subject to double taxation. Given that onshore PRRT projects are subject to state government ad valorem royalties, the combination of a royalty and PRRT is an inappropriate mix of fiscal measures. Despite this fact, the deductibility of and uplift rate applicable to resource rent tax is reasonably appropriate.

Order of deductions

The order of deductions is a difficult issue and there is no indication from the underlying theory of PRRT of the correct order.

The current order defers deductions for exploration expenditure. This order 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.

The Consultation Paper suggests changing the order of deductions to require expenditure with higher uplift rates being deducted before expenditure with lower uplifts and transferrable expenditure being deducted before project specific expenditure. The rationale for this approach appears to be to restrict the compounding impact of carry forward deductions to reduce deductible expenditure and increase the PRRT payable.

There is no correct order of deductions. However, it is important that any proposed changes to the order are considered in conjunction with the uplift rates and transferability of expenditure.

Transferability

The transferability of exploration expenditure is a crucial and integral feature of PRRT, reducing the risk of being unable to recover expenditure. It requires eligible transferrable exploration expenditure to be transferred to areas with a PRRT liability if certain conditions are met. It also provides appropriate recognition of the reduction in the rate of augmentation of general expenditure from 1 July 1990 as outlined above.

Transferability is a key element that must be retained as it provides a real incentive to encourage companies to undertake the high risk exploration activity necessary for the continued development

of Australia's petroleum resources. This is even more important in current times where the onshore gas developments are operating in a high cost environment and need to invest many billions of dollars of future capital on gas developments to maintain the supply of gas to the East Coast Australia market and Queensland LNG export commitments.

Gas Transfer Pricing

The gas transfer price is a key determining factor for PRRT in respect of integrated gas projects. The current methods were developed and considered in detail over many years and in our opinion are appropriate and effective. In addition, the ATO understands the significance of the gas transfer price to PRRT liabilities and is able to thoroughly review calculations.

The rules require an assessment of whether there is a comparable uncontrolled price (CUP) and if there is a CUP, it is preferred to the residual pricing methodology (RPM). In our experience, there is a CUP in our onshore projects, however it is appreciated that it is more difficult in an offshore context.

The RPM essentially uses a netback approach to determine the maximum price that a downstream producer will pay, and a cost plus approach to determine the minimum price an upstream producer is willing to accept. If the netback price is higher than the cost plus price, the difference will be apportioned on an equal basis between the upstream and the downstream, recognising the integrated nature of the project.

The design of the gas transfer price regulations was the subject of many years of detailed discussion and independent studies, in particular in respect of the rate of return and the split between the upstream and downstream phases. The capital allowance is not arbitrary and 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 reflect difficulties in splitting the return from integrated projects and it was considered that the most appropriate and potentially equitable solution was to split the residual price 50/50 between the upstream and the downstream phases. Santos is not aware of an alternative basis of general application. In addition, Santos considers that a netback on its own is not appropriate.

Santos notes the operation of the gas transfer price methodology is set out in significant detail in the PRRT Regulations and explanatory statements. The Organisation for Economic Co-operation and Development (OECD) has also been particularly active in recent years in providing guidance on transfer pricing and specifically how to determine a CUP.

It is important to recognise that this is a highly complex area and any consultation and review of this issue requires additional time to ensure it is considered appropriately.

What is a new project?

The Callaghan Report proposes that its recommendations apply to "new projects". The definition of a "new project" is a significant issue and will impact on investment decisions in the oil and gas industry.

It is important that any changes are not retrospective and do not impact projects that have already had investments of expenditure. Exploration expenditure carries a very low chance of success and the PRRT regime has been designed to encourage and accommodate this type of risky investment. The investment cycle for a project can last many years, starting with historic exploration that may many years later lead to the development of that initial discovery. Accordingly, it is difficult to separate the initial exploration from other parts of the cycle as they are

all related. The current definition of a petroleum project in the PRRT Act centres around a production licence and does not incorporate the whole concept of a project.

Santos has already invested billions of dollars in its projects on the basis of the current PRRT regime, and will need to spend billions more to develop these projects. It is crucial that any changes to the PRRT do not prohibit these investments.

Changes recommended by the Review to Improve the integrity, efficiency and administration of PRRT

Santos does not support Recommendation 2 which prohibits future onshore projects from combining with current onshore projects with a starting base. Santos considers this is a retrospective change to the PRRT system which contradicts the policy intent of the legislation that extended PRRT to onshore.

The starting base provisions were a fundamental element of the legislation extending PRRT to onshore and were introduced to reflect the expectation of the government that onshore projects would not pay PRRT. They recognised that there are differences in the operating environment onshore and acknowledged past investments in exploration and development onshore. The restriction of future onshore projects being able to use the starting base deductions is inconsistent with the original intent of this legislation. Santos also does not consider there is any analogy between this recommendation and the prohibition on the combination of onshore and offshore projects.

Onshore petroleum producers have already had to deal with the imposition of a new tax when PRRT was extended to onshore and have the additional 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.

Santos is generally supportive of the other recommendations to improve the integrity, efficiency and administration of the PRRT.

Conclusion

Santos considers the PRRT regime is operating as intended.

The design of the PRRT has provided companies with an incentive to invest in Australia's resources while also providing an appropriate return to the Australian community. This has resulted in very large investments in the Australian petroleum industry based on longstanding taxation arrangements.

Any options considered by Treasury to address potential design issues for the PRRT must take into account the policy objectives of the legislation, the current economic downturn in the industry and the integrated nature of the PRRT regime elements. In addition, the impact of any options must be considered on all areas of the cycle through exploration, feasibility, development and production and not merely in the early stages of large, long life projects currently in a low price environment.

Fiscal stability is also important in influencing investment in Australia's oil and gas resources and it is critical that any PRRT reforms continue to provide companies with an incentive to invest in the industry.

We would be pleased to discuss these matters in further detail with Treasury.

If you have any questions or would like to discuss the above further, please contact Heidi Edwards on (08) 8116 5850.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Anthony Neilson', with a small flourish at the end.

Anthony Neilson
Chief Financial Officer