



Submission

Business Tax Working Group Discussion Paper

Issue Date: 21 September 2012

TABLE OF CONTENTS

1.0 EXECUTIVE SUMMARY	1
2.0 ABOUT CHEVRON AUSTRALIA	4
3.0 ANALYSIS OF BUSINESS WORKING GROUP OPTIONS	5
3.1 Thin capitalisation and cap on interest deductibility	5
3.2 Depreciation.....	6
3.3 Exploration.....	8
3.4 Research and Development.....	10

1.0 EXECUTIVE SUMMARY

Chevron Australia (Chevron) welcomes the opportunity to comment on the Business Tax Working Group (BTWG) Discussion Paper (the Discussion Paper) and to contribute to broader taxation policy in Australia.

Chevron is currently developing two of Australia's largest resources projects in the North-west of Western Australia. The Chevron-operated Gorgon and Wheatstone Projects represent over \$70 billion of investment and will position Australia as a leading liquefied natural gas (LNG) supplier in the Asia-Pacific region.

Our projects will create significant long-term benefits for the Australian economy, including \$60 billion in anticipated State and Federal Government tax and royalty revenue over 30 years.¹ As such, Chevron is vitally interested in taxation policy that ensures certainty and fairness, for our long term investments in Australia.

Predictability and stability of the fiscal environment is essential to attract investment of the magnitude of Gorgon and Wheatstone.

Chevron's investment in Australia was premised on confidence in a stable and predictable fiscal environment. With long lead times and high value of investments in LNG, this confidence has been critical to Australia's success in attracting the current investment in major capital projects such as Gorgon and Wheatstone.

In Chevron's view, the current taxation system has facilitated commitments by companies including Chevron, to develop major oil and gas projects in Australia, and those commitments are currently being realised with the construction of Gorgon and Wheatstone, as well as a number of other projects around Australia.

Continuing changes in tax policy made with short term focus create uncertainty and increase sovereign risk. Australia's reputation as an attractive fiscal environment has been diminished by recent policy changes affecting the oil and gas sector, including the Clean Energy Scheme, the retrospective imposition of condensate excise, the retrospective amendment of the Petroleum Resource Rent Tax (PRRT) Act during an ongoing court dispute, the extension of the PRRT regime and retrospective transfer pricing legislation. The Parliament has also failed to pass promised company tax rate reductions.

Chevron believes that the options canvassed in the Discussion Paper would, if implemented, further erode Australia's international competitiveness and impact future investment.

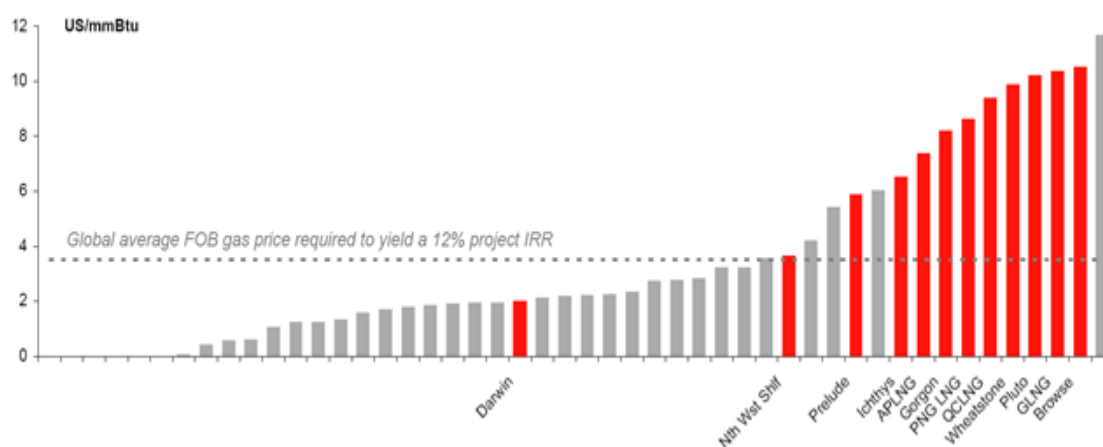
Australia has become a high-cost location for developing major capital projects. Australia is currently the most expensive place that Chevron does business in its global portfolio. The Government's Draft Energy White Paper, released in December 2011, recognises that Australia's competitiveness with other nations is being eroded, noting *'Australia is well placed on many resource development indicators, such as the 2011 World Risk Survey, where we were ranked seventh overall. However, in the 2004 survey Australia was ranked first, which shows that investment attractiveness can change quickly due to perceptions about the cost or risks associated with exploration and project development.'*²

¹ ACIL Tasman analysis

² p88, Draft Energy White Paper, Department of Resources Energy and Tourism, December 2011

As shown by Figure 1, Australian LNG projects are at the top of the global cost curve.

Figure 1: Australia Project Costs in a Global Context



Source: APPEA BTWG Submission, Macquarie Equities Research, Wood Mackenzie (2011)

In this environment, Chevron cautions that the options in the Discussion Paper would be factored into project economics and will clearly impact investment decisions for Australian projects. In particular, the options around capital allowances will have a significant adverse impact on rates of return and in turn, investment decisions.

Chevron agrees with the statement in the Discussion Paper that *'Australia's future economic growth prospects are dependent on our ability to encourage new investment and enhance productivity growth within challenging international and domestic conditions.'*³ Although petroleum resources are not mobile, the capital required to develop the petroleum resources is. Australia competes globally for capital investment. Chevron and other petroleum explorers and producers, including those based in Australia, assess opportunities on a global risk-reward basis.

While there have been a number of investment decisions made by Chevron and other oil and gas companies in recent years, those investment decisions were made in a favourable cost and revenue environment and stable fiscal regime. Future decisions in the Australian LNG industry are facing significant pressures in relation to costs, labour and productivity issues, competition from producers of LNG in other countries and technology breakthroughs such as shale gas, which will place pressure on future Australian LNG projects.

In light of this, the options in the Discussion Paper come at a time and in an environment in which current and future investment decisions are being challenged. Any additional taxation imposts on the industry will further compromise the economics of major projects and provide additional impetus for capital to move to more competitive investment destinations.

³ p8, Business Tax Working Group Discussion Paper

Chevron supports broader tax reform.

Chevron supports reducing the corporate tax rate over the medium term to 25%, in line with the recommendation by the Henry Tax Review. However, we consider that moving to a lower corporate tax rate should be done in a sustainable manner after developing a strategic reform agenda for the broader tax system. Such tax reductions should be funded by a combination of improved economic and fiscal conditions and sustainable broader based tax reform, rather than focusing narrowly on business taxes.

BTWG options should not target particular sectors.

The Discussion Paper notes '*economic conditions remain uneven, with mining and mining-related sectors experiencing robust growth, while some sectors remain under pressure.*'⁴ In Chevron's view, it does not advantage the Australian economy as a whole to penalise Chevron and the resources sector with tax measures that would disproportionately affect them. As the sector which has been driving the nation's GDP growth for several years despite global economic uncertainty, Chevron believes it is in Australia's broader economic interest to maintain policy settings that encourage continued growth and investment in the resources industry.

Chevron notes that while the Discussion Paper refers to the options as 'base broadening', in reality the options would essentially be funded by the resources sector. Companies such as Chevron are potentially triple hit, by the options canvassed, affecting the entire life cycle of our business, from how we find resources (exploration), how we develop the resources once found (capital allowances) and how we fund development and operations (thin capitalisation and interest deductibility). As a result of the potential triple hit, Chevron's operations would be negatively impacted by the revenue saving measures, in net present value terms, in the order of \$2 to \$3 billion. This cost is estimated over the expected life of our operations and is on the basis that the existing tax rules will continue to apply to our committed Gorgon and Wheatstone projects. If this is not the case, the cost to Chevron will be significantly greater. This burden is in addition to the significant future tax contributions Chevron anticipates generating for the State and Federal Governments.

Given the narrow scope of the BTWG terms of reference and the detrimental impact on future investment decisions for major capital projects in Australia, Chevron does not support any of the options canvassed in the Discussion Paper. Chevron believes the options advocated by BTWG are flawed. They do not take into consideration the complex, high risk, trade exposed and capital intensive nature of the oil and gas industry. Accordingly Chevron proposes that the BTWG recommend no changes be made to the business tax system.

⁴ p8, Business Tax Working Group Discussion Paper

2.0 ABOUT CHEVRON AUSTRALIA

Chevron is currently the largest investor in Australian petroleum exploration, appraisal and development.

Chevron has been present in Australia for almost 60 years through our oil operations on Barrow and Thevenard Islands, and later as a foundation partner in the production of Liquefied Natural Gas (LNG) and domestic gas from the North West Shelf Venture.

Chevron is also the operator for the Gorgon and Wheatstone Projects in the North-west of Australia. Together, these projects are expected to bring significant benefits to Australia including direct and indirect employment, government revenues, economic growth, investment in local goods and services and security of natural gas supply.

The \$43 billion Gorgon Project has been in construction for over two years on Barrow Island and will be Australia's single largest resources project. Gorgon will provide initial capacity of three trains totalling 15 million tonnes per annum of LNG and a domestic gas processing plant with the capacity to provide 300 terajoules per day (TJ/day) to supply gas to Western Australia. First LNG is scheduled for 2014, and the first tranche of domestic gas (150TJ/day) is currently being marketed for deliveries in 2015.

The \$29 billion Wheatstone Project reached a final investment decision in September 2011 and is now in construction. The foundation project will provide initial capacity of two trains totalling 8.9 million tonnes per year LNG and a domestic gas processing plant with the capacity to produce approximately 200TJ/day of domestic gas. First LNG is scheduled for late 2016 and first domestic gas is planned for 2017/2018.

Analysis of Chevron's projects by ACIL Tasman has found that among the significant long-term benefits for the Australian economy is an estimated \$60 billion in anticipated State and Federal Government tax and royalty revenue over 30 years. Gorgon and Wheatstone should have the flow on effect of generating almost \$50 billion in expenditure on Australian goods, services and jobs.

Chevron is Australia's most successful explorer for gas resources in Australia, having announced 15 successful discoveries since 2009. Chevron brings the expertise required to not only make discoveries which underpin our major capital projects and economic benefits for Australia, but to explore and develop resources in a safe and environmentally responsible manner. As the largest permit holder and investor in Australian petroleum acreage, Chevron is currently undertaking its largest ever Australia drilling campaign. Deepwater drilling contracts have been secured to support a planned exploration investment totalling several hundred million dollars.

Chevron strongly supports initiatives that encourage oil and gas exploration and development in Australia. As Australia's most successful explorer for gas reserves and the most significant investor in gas exploration, Chevron considers that good taxation policy contributes to the development of Australia's natural resources, as supported by Chevron's own considerable investment in our major capital projects, Gorgon and Wheatstone, and our extensive ongoing and highly successful exploration program.

Chevron's confidence in making investments in Australia needs to be underpinned by a system that provides fiscal certainty and low sovereign risk. As such we do not support any changes that erode the confidence required to facilitate the development of large, highly capital intensive and long term LNG projects.

3.0 ANALYSIS OF BUSINESS WORKING GROUP OPTIONS

3.1 Thin capitalisation and cap on interest deductibility

Chevron does not support the implementation of any of the specific options canvassed by the BTWG with regard to thin capitalisation and cap on interest deductibility.

The existing thin capitalisation rules should not be changed as they work well, they are widely understood and accepted, and provide companies with certainty and predictability in relation to the deductibility of interest on borrowings.

Chevron does not agree with the comments in paragraph 98 of the Discussion Paper that the Australian thin capitalisation rules are “overly generous” when assessed against other countries, and note that no compelling evidence has been provided to support that this is the case. Rather, the Australian thin capitalisation regime is based on all “economic” debt and therefore should have a higher safe harbor ratio than those that are limited to related party legal form debt, which is the test applied by other countries. We recommend that a detailed and current study be undertaken to compare international thin capitalisation regimes and the tax systems within which they operate prior to further considering any option to adjust the Australian thin capitalisation rules.

Chevron does not support the replacement of the existing thin capitalisation rules with a cap on interest deductibility based on a percentage of ‘earnings before interest, tax, depreciation and amortisation’ (EBITDA). We consider that this option would:

- create complexity in transition and going forward;
- not provide Government with revenue certainty as companies’ EBITDA may significantly vary from one year to another (often out of the company’s control); and
- disadvantage businesses such as Chevron which are developing capital intensive projects, which do not have sufficient profits at the time the funding is required and whose profits are subject to volatility.

If the BTWG considers that a cap on interest deductibility based on a percentage of EBITDA is appropriate, this should be offered as an optional alternative, which must be in addition to the existing ‘safe harbour’ thin capitalisation rules.

Chevron does not support the options to change the thin capitalisation regime, however, in the event that the BTWG does decide to make recommendations for changes to the thin capitalisation regime, we strongly recommend that:

- any revenue savings are more accurately understood;
- changes include all industry and investor types; and
- appropriate transition measures are put in place. We consider that 3 years is a reasonable and appropriate transitional period for existing debt arrangements to be re-organised. This period reflects the significant and complex tax and commercial considerations that would need to be dealt with, which for a large international company, may involve multiple jurisdictions. For example, a 3 year transitional period was provided for the transition of hybrid instruments into the debt / equity and thin capitalisation rules in 2001.

3.2 Depreciation

Chevron does not support the depreciation options canvassed in the Discussion Paper.

Chevron has recently made significant investment commitments in Australia through the Gorgon and Wheatstone projects on the basis of the fiscal terms that applied at that time. We expect that those same fiscal terms will continue to apply to **all assets that are developed and form part of these committed projects.**

Given that LNG projects take between 5-7 years to construct and that the depreciation of capital expenditure does not commence for tax purposes until the project assets are completed and in use (i.e. at production), we would not expect any significant additional revenue savings to be derived from the LNG industry within the 4 year time frame being contemplated by the Discussion Paper.

The long construction times and very high construction costs for LNG projects result in them having very long payback periods. Any adverse changes to the rate of depreciation (whether it is the diminishing value rate or statutory caps) will have a direct and negative impact on the project economics, which is a key factor for investment decisions. Specifically, it will detrimentally affect the project economics for any potential expansion of the Gorgon and Wheatstone projects, and any new projects.

Effective lives which underpin Australian depreciation rates are already considered to be uncompetitive when compared internationally. Taking into account long construction times, if statutory caps were removed or extended, it would further erode Australia's international competitiveness as longer asset write-off periods impede new or incremental investment decisions.

Reduction of Diminishing Value rate from 200% to 150%

Chevron does not support the option to reduce the diminishing value rate from 200% to 150% for the above key reasons, and the following.

We note the policy rationale behind the recent increase of the diminishing value rate change from 150% to 200% in the 2006-07 Budget remain appropriate and continue to hold. It was recognised that on large value assets, the diminishing value method created long tails for deductibility of depreciation which did not reflect the economic depreciation of the asset.

We further note the following extract from the 2006-07 Budget papers on the increase of the diminishing value rate from 150% to 200%:

“The current 150 per cent diminishing value rate does not reflect the true change in value of many depreciating assets. This results in depreciation rates that are generally too low for most plant and equipment. By increasing the diminishing value rate to 200 per cent, this measure will ensure that tax depreciation rates more closely align with economic depreciation”.⁵

These measures were also designed to ensure that businesses invest in new plant and equipment to remain competitive. Significantly, it was stated that:

“The measure encourages efficient investment by ensuring that depreciation deductions for income tax purposes more closely reflect an asset's actual decline

⁵ Extract from 2006/07 Budget

in value. This will enhance productivity and help sustain strong economic growth.”⁶

Chevron considers the policy objectives for introducing the 200% diminishing value rate remain relevant, and should be retained.

Removal of the statutory cap

Chevron does not support options to remove the statutory caps for the oil and gas industry for the above key reasons and the following.

Chevron considers that the policy reasons outlined when statutory caps were introduced in 2002, remain valid today, that is:

“...to address the broader national interest where large increases in safe harbour effective lives resulting from the review of the existing effective life determination *would have a significant effect on investment in industries with national economic implications.*”⁷ (*Emphasis added*)

The explanatory memorandum of the Bill introducing the statutory cap provision in 2002 noted that the Government had considered alternative options including applying the statutory caps as a transitional measure. These were determined to be either inferior or unworkable. The explanatory memorandum noted:

“The option of applying statutory caps as a transitional arrangement was considered ..., however, would have continued to provide considerable medium and long term uncertainty to industry about the effective life that would apply to projects, particularly if the statutory cap was phased up to the Commissioner’s Determination. A fixed time for removing the cap would have also risked sub-optimal investment resulting from the incentive to ensure that a taxpayers capital allowances deduction is based on the statutory cap. In addition, such a transitional measure would not only have limited the benefits of the policy measure, but would have also introduced further complexity and uncertainty to the administration of tax law in relation to capital allowances. Transitional arrangements were therefore considered to be inappropriate.

The option of establishing a mechanical process that considers changes in effective lives and applies detailed prescribed criteria accounting for specific increases in effective lives was thought to be inflexible and complex to administer. A number of rigorous tests would have been needed under this approach and it was considered to be unworkable.

The use of a purely statutory write-off, rather than statutory caps, was also considered, but it would have undermined the integrity of the effective life based capital allowance system. For this reason, such a process was considered to be unwise.”⁸

Chevron considers that the policy objectives for introducing the statutory caps rate remain relevant, and should be retained.

⁶ Treasurer’s Media Release (09/05/2006 No. 41)

⁷ Paragraph 4.47, Explanatory memorandum of *Tax Law Amendment Bill (No.4) No.53 of 2002*

⁸ *Paragraph 4.57 to 4.59 of EM of TLAB (No.4) No.53 of 2002*

3.3 Exploration

Chevron does not support any options to remove or defer immediate deductions for exploration expenditure for the following reasons:

Exploration expenditure including feasibility

Exploration activities in the oil and gas industry are capital intensive and have a high risk of failure. Therefore with respect to costs that relate to unsuccessful exploration activities, we consider that any policy other than their immediate deductibility is unjustified and inappropriate.

Where exploration activities identify oil and gas resources, the viability of the resource is not known, and this is often not known for years or decades. The transition from discovery to production, involves years or decades of assessment and decision making. Significant resources are ordinarily invested in appraisal and feasibility activities to determine if the hydrocarbon can be commercially exploited. Decisions relating to the viability and ultimately the commercial development of a resource are based on a wide variety of factors that change over time. By way of example, it took almost two decades to determine the commercial viability and reach a commitment to develop the Gorgon gas field. The lengthy time periods between a discovery and a decision to develop the resource clearly demonstrates the impracticalities that would arise if a taxpayer was required to nominate an effective life over which to deduct the expenditure, even if an asset exists.

Accordingly, at the time the exploration activity is undertaken (whether successful or not) a company will not know if a production decision will be made. At this point there is no identified asset, nor any understanding of economic life of the potential resulting asset. Therefore, and consistent with the conclusions of a series of prior reviews, including the Asprey Taxation Review in 1976, through to the Ralph Review in 1999, Chevron believes there are sound policy and practical reasons why the deductibility of exploration costs, other than immediately, is not appropriate.

As a significant investor in gas exploration in Australia, Chevron views exploration including feasibility as a part of its ordinary and recurrent business activities and therefore an ordinary business cost which is deductible under the general deduction provisions of the Tax Act.⁹ Introducing any measure that specifically denies the immediate deductibility or codifies a deduction over time for exploration or feasibility costs would be akin to denying a company in the retail or banking industry a deduction for ordinary business costs relating to advertising or expenditure incurred in developing its products or services. That is, it would represent the imposition of a barrier for our business as opposed to the removal of a concession.

The reason that Chevron views these costs as an ordinary business outgoing is because Chevron spends several hundreds of millions every year on exploration activities and feasibility work across a wide portfolio of exploration assets. At any one time, we have assets at various stages of progression across these activities. Furthermore, the majority of exploration conducted in our industry is typically performed by third party service providers, as such, it is unnecessary for Chevron to acquire or hold equipment needed for such exploration.

⁹ Income Tax Assessment Act 1997

First use of Exploration Assets

Chevron does not support any of the options canvassed relating to the removal of an immediate deduction for assets 'first used' for exploration.

It would be uncommon for companies such as Chevron to acquire tangible assets for exploration activities. As stated above, Chevron would typically use third party service providers to perform its exploration activities. As a result it would be uncommon for Chevron (and indeed large oil and gas companies) to immediately deduct the cost of these assets.

The transfer of interests in exploration permits or retention leases is an important commercial practice that is undertaken in the oil and gas industry on a routine basis. The gas fields required to underpin a commercial development rarely lie in a single permit or lease area. Rather, they may either straddle multiple adjacent permits or leases or be geographically separated. For these reasons, coupled with the sharing of risk and access to appropriate expertise or funding for the project, large scale gas developments in Australia involve complex joint venture arrangements.

Under such arrangements, one of the key barriers to a project proceeding is commercial and equity misalignment among joint venture partners. The misalignment is often resolved via the sale and purchase of equity interests (i.e. transfer of permits or leases). The current 'first use' rules facilitate these transactions without significant tax leakage. Such transactions which facilitate the progression of the project may not occur if there was significant tax leakage, particularly where the parties are substantially in the same economic position (i.e. do not gain additional economic value). An example of this relates to the series of equity transactions as between the Gorgon project partners in 2005, whereby the ownership of equity interests were aligned to facilitate the commercial progression of the project. This occurred some four years prior to the investment decision for the Gorgon project.

We further note, due to the high cost associated with the oil and gas industry, fewer smaller companies engage in exploration and related activities (in particular offshore exploration) as costs are prohibitive. Typically, large oil and gas companies hold the relevant permits or leases and conduct the exploration activities. As such, it is uncommon for transactions involving the sale and purchase of these intangible assets to take place between small and large companies.

Accordingly, it is important that the taxation system does not act as an impediment to the efficient and commercial operation of the industry. In this context, the current treatment is considered to facilitate the most efficient outcomes for the industry.

3.4 Research and Development

Chevron does not support any option to remove or reduce research and development concessions.

Chevron supports the policy of encouraging entities to perform research and development to improve business productivity and Australia's economic competitiveness. Although it is contended that large business may not need encouragement to invest in research and development, it is often large investors in research and development that deliver largest economic benefits to Australia, for instance through research foundations that require significant capital investment. For example, the development of carbon dioxide injection technology on a commercial scale for Chevron's Gorgon project.

Furthermore, for Chevron, the research and development tax concession has encouraged the establishment of a technology centre in Perth to assist in the identification of new research and development opportunities in exploration and production of new oil and gas supplies.