Petroleum Resource Rent Tax Assessment Amendment Bill 2011

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Petroleum Resource Rent Tax Assessment Amendment Bill 2011

**Date introduced:** 2 November 2011  
**House:** House of Representatives  
**Portfolio:** Treasury  

**Commencement:** The following commence on 1 July 2012:

- Schedule 1: items 1 to 10, 12 to 24, and 26 to 46  
- Schedule 2: Part 1  
- Schedules 3 and 4  
- Schedule 5: items 1 and 6 to 12, and  
- Schedule 6: Parts 2 and 3.

The following commence on 1 July 2012 subject to the following provisos:

- Schedule 1:
  - item 11 will not commence if proposed *Tax Laws Amendment (2011 Measures No. 8) Act 2011* receives Royal Assent on or before 1 July 2012, and  
  - item 25 commences on the later of (a) 1 July 2012 and (b) immediately after the commencement of Schedule 2 to proposed *Tax Laws Amendment (2011 Measures No. 8) Act 2011*. Item 25 will not commence if (b) does not take place.

- Schedule 2: Part 2 commences on a day to be fixed by Proclamation. If Part 2 does not commence within the six months period beginning on the day the Bill receives Royal Assent, Part 2 will commence on the first day after that period.

- Schedule 5: items 2 to 5 commence on the later of (a) immediately after the commencement of items 1 to 10 of Schedule 1 and (b) immediately after the commencement of Schedule 3 to the proposed *Minerals Resource Rent Tax (Consequential Amendments and Transitional Provisions) Act 2011*. Items 2 to 5 will not commence if (b) does not take place, and

- Schedule 6: Part 1 commences on the later of (a) immediately after the commencement of items 1 to 10 of Schedule 1 and (b) immediately after the commencement of section 3 of the *Clean Energy Act 2011*. Part 1 will not commence if (b) does not take place.

**Links:** The links to the Bill, its Explanatory Memorandum and second reading speech can be found on the Bill's home page, or through [http://www.aph.gov.au/Parliamentary_Business/Bills_Legislation](http://www.aph.gov.au/Parliamentary_Business/Bills_Legislation). When Bills have been passed and have received Royal Assent, they become Acts, which can be found at the ComLaw website at [http://www.comlaw.gov.au/](http://www.comlaw.gov.au/).

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Purpose

The main purpose of the Petroleum Resource Rent Tax Assessment Amendment Bill 2011 (the Bill) is to establish the framework for extending the Petroleum Resource Rent Tax (PRRT) to the North West Shelf and to onshore petroleum projects by amending the *Petroleum Resource Rent Tax Assessment Act 1987* (PRRTAA 1987).

Background

The following is a simplified description of the PRRT. The PRRT is levied on petroleum projects in offshore areas other than the North West Shelf, which is subject to Commonwealth excise and royalties. The PRRTAA 1987 which imposes the PRRT, was effective from 15 January 1988. The PRRT is levied on a project basis. Petroleum products to which the PRRT applies include crude oil, condensate, natural gas, and liquefied petroleum gas. The taxable profit of a project for the purposes of the PRRT is the excess of assessable receipts over the sum of deductible expenditures and exploration expenditures transferred from other projects. In general, assessable receipts are proceeds from the sale of petroleum and petroleum-based products. Exploration, project development and operating expenditures are generally deductible. Expenditures are compounded (increased) at different rates (depending on the nature of the expenditure and when it was incurred) and are carried forward for deducting against future assessable receipts. PRRT is payable when assessable receipts exceed deductible expenditures, and is levied at the rate of 40 per cent.

The Government established the Policy Transition Group to examine, among other things, the treatment of transitioning projects into the PRRT. In December 2010, the Policy Transition Group reported on the taxation of resources, both mining and petroleum. The Bill is faithful to the Policy Transition Group recommendations that relate to the proposed legislation.

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2. For a fuller description, see Explanatory Memorandum, Petroleum Resource Rent Tax Assessment Amendment Bill 2011, pp. 9-16.
4. The rates are called augmentation rates in the PRRTAA 1987.
6. For a list of the PTG’s recommendations relating to the PRRT, see ibid., pp. 169-175.

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Features of the Bill

The following is a simplified outline of some of the Bill’s features.

**Australian laws:** In order to define a production licence for onshore projects, the Bill draws on state and territory legislation. The Bill, in effect, extends the definition of production licences issued under Commonwealth laws to include production licences issued under state and territory legislation. The Bill also relies on state and territory legislation for definitions of other terms such as exploration permits, retention licences, pipeline licences, petroleum-related infrastructure, and production licence notice.

**Carbon emission permits:** The cost of buying carbon emission permits is deductible expenditure.

**Combining production licences:** The PRRT is essentially a project-based tax, and a production licence is generally a basis for determining what constitutes a project. Under the PRRTAA 1987, the Minister has the power, using certain criteria to determine when several offshore projects should be combined into one project for the purposes of the PRRT. The Bill retains these criteria and adds new criteria for onshore projects. In short, the Bill allows the Minister to combine several onshore production licences into one project where there are downstream activities that are related to the multiple licences. To combine an offshore project with an onshore project, the projects must also be related.

**Extension of deduction expenditures:** The Bill proposes to include in deductible expenditures, costs associated with onshore projects such as native title payments that are not a feature of offshore projects. Resource taxes include Commonwealth, state and territory royalties, and the crude oil and condensate excise. The Bill makes resource tax expenditure deductible against assessable receipts thus avoiding double taxation. Environmental expenditures will also be deductible.

**Extension to more projects:** The Bill extends the PRRT to petroleum and petroleum products produced onshore and to the North West Shelf offshore project.

**Extensions to the tax base:** There are several extensions to the tax base. First, the Bill proposes to subject shale oil to the PRRT by including shale oil in the definition of a marketable petroleum commodity. Second, the PRRT will also apply to coal seam gas. However, if coal seam gas is produced as part of the process of extracting coal, the gas is treated as if it were part of coal mining, and therefore subject to the proposed mineral resources rent tax (MRRT). Third, the PRRT will apply to income generated from non-petroleum products and services—that is, ‘incidental income’ such as that generated from services provided in relation to carbon capture and storage—but only in so far as the income is related to the project. Costs incurred in generating incidental income will be deductible. Fourth, where a taxpayer receives a resource tax refund, it is treated as assessable income.

**Functional currency rules:** Some companies keep accounts in foreign currency. The PRRT, on the other hand, is calculated in Australian dollars. Division 7 of the PRRTAA 1987 governs the rules.

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under which taxpayers can opt to ‘translate’ foreign currency amounts into Australian dollars. The Bill allows taxpayers transitioning to the PRRT to apply to use the functional currency rules.

**Starting base and look-back**: In the case of projects already subject to the PRRT, undeducted expenditures can be carried forward for deduction against assessable receipts in future years. Transitioning projects—that is, projects that will be subject to the PRRT—have also incurred deductible expenditures. To put transitioning projects on a footing similar to projects already subject to the PRRT, taxpayers will have to determine what deductible expenses transitioning projects have incurred. The Bill contains two options for taxpayers to value undeducted expenditures. The first option is the ‘starting base’ method; the second is the look-back method. Taxpayers have two choices under the starting base method: market value or book value. The look-back approach may, in general, incorporate expenditures from 1 July 2002 to 1 July 2012 that would have been deductible had the PRRT applied to the transition project.

**Uplift (augmentation) factors and the five-year rule**: Deductible expenditures fall into different categories and are subject to uplift factors (otherwise referred to as augmentation rates). The amounts of deductible expenditures that are subject to the uplift factors are limited by the ‘five-year rule’. Under this rule, the uplift factors generally do not apply to expenditure incurred more than five years before a relevant project production licence came into effect. The ‘relevant pre-commencement day’ establishes the day from which the five-year rule applies. The Bill extends the five-year rule to onshore projects and to the North West Shelf project.

**Constitutional considerations**

Under section 114 of the Constitution, neither the states nor the Commonwealth can tax the property of the other. The PRRT is imposed on profits derived by the taxpayer, which is not the property of the states. States will continue to receive royalties and this expense is deductible. The three imposition Bills accompanying the Bill—the Petroleum Resource Rent Tax (Imposition-Customs) Bill 2011, Petroleum Resource Rent Tax (Imposition-Excise) Bill 2011, and the Petroleum Resource Rent Tax (Imposition-General) Bill 2011 state that they do not impose a tax on a property of a state.

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Further, because of section 55 of the Australian Constitution, the actual imposition of taxes has to be achieved in stand-alone Bills that deal only with that. This is why there are separate ‘imposition’ Bills in the package.

**Basis of policy commitment**

On 2 July 2010, the Government announced that it would extend the PRRT to all onshore and offshore oil and gas projects including the North West Shelf starting 1 July 2012. The PRRT will not, however, apply to the Joint Petroleum Development area in the Timor Sea, which is subject to the Timor Sea Treaty. The date of the announcement is incorporated into some of the Bill’s provisions.

**Committee consideration**

The Bill has been referred to the Senate Economics Legislation Committee for inquiry and report by 14 March 2012.

**Policy position of non-government parties/independents**

The Coalition is opposed to the legislation as are Messrs Crook and Katter. The Australian Greens are in favour of the legislation as are Messrs Oakeshott, Wilkie and Windsor.

**Position of major interest groups**

The Australian Petroleum Production and Explorations Association (APPEA) is the main organisation representing petroleum explorers and producers. On 29 September 2011, APPEA made a submission to the Treasury on the exposure draft of the PRRT legislation. Some of the APPEA’s proposals were adopted in the Bill and others were not.

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10. J Gillard (Prime Minister), W Swan (Treasurer) and M Ferguson (Minister for Resources and Energy), *Breakthrough agreement with industry on improvements to resources taxation*, media release, no. 55, 2 July 2010, viewed 23 November 2011, [http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id%3A%22media%2Fpressrel%2F917X6%22](http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id%3A%22media%2Fpressrel%2F917X6%22)


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Financial implications

There are numerous reasons the effects of extending the PRRT on Australian Government revenue are unknown and why any attempt to forecast revenue, especially over the long term would, at this stage, be speculative. The Australian Government will incur both revenue gains and losses. On the one hand, the Government will gain PRRT revenue from extending the PRRT to the North West Shelf and onshore projects. On the other hand, projects to which the PRRT will extend will continue to be subject to excise but the excise paid will be credited against the PRRT. The net effect on revenue is unknown.

A second reason long-term revenue effects are unknowable is that future developments in the shale oil and coal seam gas industries—both of which will be subject to the PRRT—are uncertain. The decision to establish an Independent Expert Scientific Committee to advise governments about the consequences for water resources of coal seam gas and large coal mining developments has added to this uncertainty.

Thirdly, the response of the states to the extension of the PRRT is unclear. Onshore projects are subject to state royalties. Under the Bill, resource tax expenditure—Commonwealth and state—will be deductible expenditure in certain circumstances. Deductibility provides the states with an incentive to increase petroleum and gas royalties.

Finally, revenue depends on the trajectory of future oil and gas prices and project costs that are uncertain.

Main issues

The extension of the PRRT is likely to impose considerable upfront and on-going costs on both the companies that will be subject to the PRRT and on the Australian Taxation Office which will be responsible for administering the legislation.

The valuation of starting base assets using the market value, book value and look-back approaches for transitional projects is likely to be problematic for some taxpayers and in practice, many taxpayers are likely to find that their options are limited and difficult.

First, with respect to the market valuation method, many projects at 2 May 2010 were on-going and not for sale so it may be difficult to establish market values for such projects. An option for some taxpayers may be to have professional estimates of market value.

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15. J Gillard (Prime Minister) and W Swan (Treasurer), New focus on scientific evidence to build community confidence in coal seam gas and coal mining, media release, no. 141, 21 November 2011, viewed 23 November 2011, http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=id%3A%22media%2Fpressrel%2F1242039%22

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For many taxpayers, book value may be the only feasible approach however book value is subject to limitations especially where assets are recorded at historical cost. Unless historical costs have been adjusted to reflect inflation (such as by asset revaluations to reflect current replacement cost less depreciation), asset values may be understated. To the extent that historical book valuations understated current values, the value of deductible expenditures will also be understated. This problem may also occur where assessments of market values are based partly on book values.

The look-back method requires historical data. The Bill recognises this in proposed clause 20 which provides, among other things, that expenditure incurred between 1 July 2002 and 30 June 2010 is deductible only if the taxpayer has prepared records and retained them in order to substantiate claims. This could potentially disadvantage taxpayers who have not kept records in the form required to determine PRRT liability.

The Policy Transition Group, in recommendation 82, recommended that actual expenditure over the eight year period from 1 July 2002 to 1 May 2010 should apply under the look-back method. The start date seems to be arbitrary—especially given that the lives of some petroleum projects may extend over decades—and so could disadvantage taxpayers who incurred expenditure before then. The North West Shelf, for example, has been producing gas for more than 25 years. Santos started to produce gas in 1969.

With respect to acquired interests, as a general principle, undeducted expenditure is inherited by the new owner upon the acquisition of a project or interest in a project but can only be used against profits derived from that project. Under the look-back option, the Bill contains rules for interests acquired between 1 July 2007 and 2 May 2010. In particular, the Bill deems starting base expenditure and acquired exploration expenditure incurred between 1 July 2007 and 2 May 2010 to have incurred on 2 May 2010. Both dates are arbitrary. The PTG makes no mention of 1 July 2007 in its recommendation 87 that relates to applying the look-base starting base.

Key provisions

The following discussion is an introduction to key provisions and is necessarily simplified. Readers should consult the Bill and the Explanatory Memorandum for a fuller understanding of the provisions.

17. See Part 1 of Schedule 4 of the Bill, p. 53.

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Schedule 1—Extension to onshore projects etc.

Among other things, Schedule 1 invokes other Australian laws—mainly state and territory laws—to extend definitions in the PRRTAA 1987 to onshore projects. Items 1 and 7 (summarised below) are examples. Items 4, 6, 10, 17, 19, 21, 22, and 24 similarly rely on other Australian laws for definitions.

Item 1 extends the definition of ‘access authority’ in section 2 of the PRRTAA 1987 to onshore projects by including an authority or right issued under another Australian law to carry on, in relation to petroleum, specified operations in a specified area (other than an authority or right that is an exploration permit, retention lease, production licence or infrastructure licence).

Item 3 establishes 1 July 2012—the applicable commencement date—as the day when the PRRT will apply to transitional projects.

The existence of exploration permits is a key to the PRRT. Item 7 extends the definition of exploration permit to onshore projects by invoking another Australian law which allows the holder to explore for petroleum, recover petroleum for appraisal purposes but not produce petroleum.

Item 11 incorporates shale oil into the definition of marketable petroleum commodity, thereby making proceeds from the sale of shale oil an assessable receipt. Item 16 includes oil shale in the definition of petroleum.

Item 14 defines onshore area as the area of a state or territory that is not classified as offshore under the Offshore Petroleum and Greenhouse Gas Storage Act 2006 (the definition also excludes the Joint Petroleum Development Area in the Timor Sea). Item 15 similarly defines an onshore petroleum project. In short, a project is onshore if it is not defined to be offshore.

The effect of item 29 is to treat the North West Shelf as a single project.

Item 36 deals with the combining of projects, and contains the criteria that the Resources Minister must consider when deciding whether to combine several projects into a single project. Item 36 repeals subsection 20(1) and substitutes new subsection 20(1). The latter contains criteria that are common to both onshore and offshore projects (for example, proposed paragraph 20(1)(b)) but also separate criteria for onshore and offshore projects. Proposed paragraph 20(1)(c) contains the additional criterion for onshore projects, namely, that the projects to be combined must involve further processing or treating of any petroleum or marketable petroleum commodity. In the case of offshore projects, proposed paragraph 20(1)(d) adds the criterion that the Resources Minister must have regard to physical features such as geological, geophysical and geochemical features. If the Minister considers that the projects are sufficiently related, the Minister must issue a certificate to the effect that the projects are to be treated as a single project.
Schedule 2—Assessable receipts

Part 1—Amendments commencing on 1 July 2012

The Bill proposes to extend the definition of assessable receipts to include incidental production receipts. Item 1 does this while item 5 adds new section 29A which defines assessable incidental production receipts. In essence, they are receipts from the sale of goods and services related to carbon capture and storage (proposed subsection 29A(1)) where the sale is not of a petroleum or petroleum commodity (proposed paragraph 29A(1)(b)) and eligible expenditure was incurred that relates to the sale (proposed subsection 29A(2)). Such expenditure is deductible against incidental income.

Item 10 makes 1 July 2012 the starting date when receipts from onshore production or the North West Shelf become assessable.

Item 11 inserts proposed subsection 31AA. The effect is to ensure that expenditure incurred before 1 July 2012 on onshore petroleum projects, or the North West Shelf or pre-combination projects is included in eligible real expenditure and therefore deductible against assessable receipts. In other words, item 11 ensures that the projects will be treated as if the PRRTAA 1987 had applied to them.

Schedule 3—Deductible expenditure

The Bill draws on Australian law to apply the PRRT to onshore projects. Australian law encompasses Commonwealth, state and territory laws. Item 2 inserts into section 2 of the PRRTAA 1987 a definition of Australian law. This is the same as subsection 995-1(1) of the Income Tax Assessment Act 1997.

All resource taxes—Commonwealth, state and territory—will be deductible. Item 3 inserts ‘resource tax expenditure’ into the definition of eligible real expenditure in section 2. Item 7 inserts new paragraph 32(fa) into section 32 of the PRRTAA 1987 that lists deductible expenditures.

Item 6 extends the definition of petroleum project to include operations and facilities for an environmental purpose, in relation to the carrying on or provision of the operations, facilities and services in petroleum projects. Item 6 thus ensures that such environmental expenditure is deductible.

Sections 33 to 36 of the PRRTAA 1987 deal with uplift factors. Items 8, 9, 10, 12 and 13 extend the uplift factors now applying to the Bass Strait project to the North West Shelf thus treating both equally.

Item 11 repeals paragraph 34A(1)(a), which deals with class 2 augmented bond rate general expenditure, and substitutes new paragraph 34A(1)(a). According to the Explanatory Memorandum:

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The definition of ‘relevant pre-commencement day’ in the Schedule to the PRRTAA 1987 has been amended to include a notice day to accommodate onshore projects and the North West Shelf project [Schedule 3, item 20]. Section 34A Class 2 augmented bond rate general expenditure has also been amended to include a notice day to accommodate onshore projects and the North West Shelf project [Schedule 3, item 11]. Both these amendments ensure that a day can be used to apply the ‘5 year rule’ to the North West Shelf project and onshore projects.\(^22\)

**Item 14** inserts **proposed section 35C** which deals with resource tax expenditure. The broad effects of **proposed section 35C** are first, to make all resource tax expenditures (Commonwealth and state) deductible and second, to ensure that unused expenditures can be carried forward and uplifted at the long-term bond rate plus five per cent. **Proposed section 35C(1)** deals with projects that are not combined and **proposed section 35C(2)** with combined projects. In the former, resource tax expenditure has two elements: actual expenditure and expenditure deemed under **proposed subsection 35C(5)** or Division 5. In the case of combined projects, deductibility depends on the financial year in question and has three components: expenditure in the financial year incurred before combination (**proposed paragraph 35C(2)(a)**), deemed expenditure as above (**proposed paragraph 35C(2)(b)**), and if the financial year in question is the year when the pre-combination certificate came into effect, expenditure on the pre-combination projects (**proposed paragraph 35C(2)(c)**). **Proposed subsection 35C(4)** provides for the conversion of resource tax expenditure into a deductible amount. This is obtained by dividing the amount of expenditure by the PRRT rate as shown in the example in the Explanatory Memorandum.\(^23\) Paragraphs 4.23 to 4.33 of the Explanatory Memorandum outline the operation of **proposed section 35C**.\(^24\)

Section 37 of the PRRTAA 1987 defines exploration expenditure which is eligible real expenditure. **Item 16** adds to this definition environmental expenditure that is incurred in relation to the carrying on or provision of operations, facilities and services. The definition in **item 16** is identical to that for a ‘petroleum project’ in **item 6**.

Section 44 of the PRRTAA 1987 defines excluded expenditure, that is, expenditure that is not deductible. Paragraph 44(e) now has a blanket ban on private override royalties. **Item 18** modifies this to allow various payments made under the *Native Title Act 1993* and other laws dealing with Aborigines and Torres Strait Islanders to be deductible. The reasons for this change are described in paragraphs 5.86 to 5.88 in the Explanatory Memorandum.\(^25\)

Taxpayers may elect to avail themselves of the functional currency provisions in Division 7 of the PRRTAA 1987. **Item 19** extends this to taxpayers who will be subject to the PRRT. Taxpayers must make an election to do so within 30 days after the commencement of **Schedule 1** to the Bill, namely, 1 July 2012.

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22. Explanatory Memorandum, op. cit, paragraph 4.12, p. 57.
23. Ibid., paragraph 4.27, p. 61.
24. Ibid., paragraph(s) 4.23-4.33, pp. 60-63.
25. Ibid., p. 84.

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The uplift factors are limited by the five-year rule. The relevant pre-commencement day establishes the day from when the five-year rule applies. Relevant pre-commencement day is defined in clause 1 of Part 1 in the Schedule to the PRRTAA 1987. Item 20 repeals this definition and substitutes a new definition. The Explanatory Memorandum states that item 20 and item 11 amend the existing definition to include a notice day so that the five-year rule can be applied to onshore projects and the North West Shelf project.26

Schedule 4—Starting base for onshore petroleum projects and the North West Shelf project

Schedule 4 has two parts: Part 1—Main amendments and Part 2—Other amendments.

Part 1—Main amendments

The PRRTAA 1987 allows taxpayers to deduct certain expenditures from assessable receipts. The Bill proposes similar arrangements for taxpayers to whom the extension of the PRRT will apply. Accordingly, a taxpayer will be entitled to establish an asset base. Taxpayers can choose between using market value, book value or look-back to establish the value of their asset bases.

Item 2 makes ‘acquired exploration expenditure’ and ‘starting base expenditure’ eligible for deduction by inserting them into the definition of eligible real expenditure. Item 8 incorporates acquired exploration expenditure and starting base expenditure into the list of deductible expenditures.

Item 10 inserts proposed section 35D which defines acquired exploration expenditure. Proposed subsection 35D(1) specifies what constitutes acquired exploration expenditure where projects have not been combined and proposed subsection 35D(2) for combined projects. The Explanatory Memorandum states:

A new deduction provision has been inserted within Division 3 of the PRRTAA 1987 to incorporate acquired exploration expenditure within the PRRT deductions framework [Schedule 4, item 10, section 35D]. Under this provision, undeducted acquired exploration expenditure in a year is subject to an uplift of LTBR + 15 per cent for the five years following 2 May 2010, and LTBR + 5 per cent thereafter [Schedule 4, item 10 subsections 35D(3) and (4)]. Acquired exploration expenditure is non-transferable, and occurs prior to starting base expenditure in the order of deductions [Schedule 4, items 2, 8, 9, 51 and 52].27

Item 10 also inserts proposed section 35E which defines starting base expenditure. Proposed section 35E distinguishes between starting base expenditure for projects that are not combined (proposed subsection 35E(1)) and combined projects (proposed subsection 35E(2)). Both are

26. Ibid., p. 57.
27. Ibid., p. 91-92.

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subject to uplift factors (proposed subsection 35E(3)). The Explanatory Memorandum gives the following reason for inserting proposed section 35E:

A new category of deductible expenditure is inserted into Division 3 of the PRRTAA 1987 known as starting base expenditure, to allow the starting base amount to be deductible against assessable receipts received in relation to a project. [Schedule 4, item 10, section 35E].

Item 11 repeals section 45 which deals with the time of incurring expenditure and substitutes proposed section 45. Proposed subsection 45(5) contains a table for the starting base days under the three options (book value, market value and look-back). In the case of the book value and market value approaches, the starting base day is 1 July 2012 for an onshore petroleum project where the project is based on an exploration permit or retention lease that came into existence before 2 May 2010 (proposed subsection 45(2)) and the North West Shelf (proposed subsection 45(4)). (The starting base days under the look-back approach are discussed below).

Proposed Schedule 2—Starting base for onshore petroleum projects and the North West Shelf project

Item 16 inserts Schedule 2 into the PRRTAA 1987, which now has only one Schedule (which becomes Schedule 1). Proposed Schedule 2 consists of five Parts:

- Part 1—Preliminary
- Part 2—Choosing a valuation approach
- Part 3—Starting base amounts
  - Division 1—Starting base amounts
  - Division 2—Starting base assets
  - Division 3—Valuation of starting base assets, and
  - Division 4—interim expenditure
- Part 4—The look-back approach, and
- Part 5—Starting base returns and assessments.

Part 2—Choosing a valuation approach

Part 2 of proposed Schedule 2 deals with choosing a valuation approach.

Clauses 3 and 5 contain three approaches: the book value approach, the market value approach and the look-back approach. The taxpayer must inform the Commissioner of Taxation, by means of a starting base return, the approach that the taxpayer has chosen (subclauses 3(2) and 3(3)).

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28. Ibid., paragraph 5.91, p. 84.

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Clause 4 provides, in essence, that where the book value approach is adopted, it must be based on a financial report that is prepared using proper accounting standards.

Part 3—Starting base amounts

Taxpayers must determine the starting base amounts under the market value and book value approaches. This in turn requires taxpayers to determine which assets can be included in the starting bases and how to value them. Clause 10 defines what a starting base asset is and what is not. Starting base assets are property or non-property rights that existed before 2 May 2010 in a production licence, retention lease or exploration permit subject to the condition that the property or non-property right was used to conduct project activities (subclause 10(1)). Subclause 10(2) specifies items that cannot be included in the book value such as prospecting information and the extremely vague ‘rights and interests constituting the petroleum project’ (paragraph 10(2)(a)(i)) while subclause 10(3) specifies items that can be included in the market value (such as mining, quarrying or prospecting information, or rights to such information).

Clause 7 deals with the value of starting base amounts. In the case of the book value approach, the starting base amount is the sum of the book value of starting base assets (paragraph 7(1)(a)) and adjusted interim expenditure (paragraph 7(1)(b)). Adjusted interim expenditure is expenditure on assets incurred between 2 May 2010 and 30 June 2012 plus augmentation of this expenditure.

Clause 16 contains the augmentation factor:

... both the value of starting base assets and interim expenditure amounts are uplifted on 1 July 2012 for the total interim period during which the starting base assets were continuously held. The amount is uplifted by the long term bond rate plus 5 per cent (LTBR + 5 per cent) over the relevant period.29

The starting base value under the market value approach is the sum of:

- the market value of assets unless the valuation method for coal seam gas (see below) is used (paragraph 7(2)(a))
- coal seam gas amounts (paragraph 7(2)(b)), and
- interim expenditure (discussed below) (paragraph 7(2)(c)).

Clause 8 provides an alternative way of valuing coal seam gas assets under the market value option. The Explanatory Memorandum states:

To reduce compliance costs, an alternative valuation method for determining the market value of the starting base assets is available for project interests that relate to coal seam gas resources, in circumstances where the project to which that interest relates has been the subject of a recent market transaction.30

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29. Ibid., paragraph 5.8, p. 68.
30. Ibid., paragraph 5.7, p. 68.

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This coal seam gas method requires information on certain things such as estimated reserves (subclause 8(2)).

Clause 12 deals with the book value of starting base assets. The Explanatory Memorandum states:

Where the market value or book value approach is chosen, the starting base amount as at 1 July 2012 will comprise the sum of either:

- the market values of starting base assets (including rights to the resources) at 2 May 2010; or
- most recent audited accounting book values of starting base assets (not including rights to the resources) available at that time; and
- capital expenditure incurred in relation to the interest during the interim period between the time the starting base asset values were determined and 30 June 2012. 31

Paragraph 12(2)(a) contains the audited financial report requirement. The report must have been prepared in the 18 months before 2 May 2010 (paragraph 12(2)(b)). Paragraph 12(2)(b) also applies the uplift factor to the value of starting base assets to determine book value of assets.

Clause 13 deals with the market value of starting base assets. Subclause 13(1) provides that market value is the value on 1 May 2010. Market value excludes any liability to make private override royalty payments (subclause 13(2)).

As noted above, under clause 7, market value includes interim expenditure. Clause 15 contains three ways of determining the amount of interim expenditure depending on the nature of the asset—a depreciating asset, a capital gains tax asset that is not a depreciating asset, and mining capital expenditure. Mining capital expenditure must be incurred between 2 May 2010 and 30 June 2012. Paragraphs 5.57 to 5.64 of the Explanatory Memorandum discuss the treatment of interim expenditure more fully. 32

Part 4—The look-back approach

The look-back approach—as with the book value and market value approaches—allows the deduction of expenditures incurred before the PRRT was extended. The Explanatory Memorandum states:

The existing provisions of the PRRTAA 1987 will apply to expenditure incurred during the look-back period. 33

The look-back approach generally includes:

... expenditure incurred from 1 July 2002 that would have been deductible had the PRRTAA 1987 applied to that interest at that time ... 34

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31. Ibid., paragraph 5.6, p. 68.
32. Ibid., pp. 79-80.
33. Ibid., paragraph 5.104, p. 88

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The table in subclause 45(5) shows the general start date under the look-back approach as 1 July 2002. However, the table also shows that where a person held an interest in a project at the start of 2 May 2010, and had first acquired that interest (or in the case of a company had been acquired) on or after 1 July 2007, the date from which expenditures can be deducted is the date of acquisition of the interest.

Under the look-back approach, the Bill contains rules for interests acquired between 1 July 2007 and 2 May 2010 (subclauses 18(1) to 18(5)). First, expenditure outlaid in acquiring the interest is generally deductible but excludes expenditure related to non-project activities. Second, acquisition costs exclude acquired exploration expenditure. Third, any recognised starting base expenditure and acquired exploration expenditure related to interest acquired between 1 July 2007 and 2 May 2010 is deemed to have incurred on 2 May 2010. Subclause 18(1) deals with the first point, namely, that starting base expenditure includes acquisition expenditure. Subclause 18(3) limits acquired starting base expenditure to project-related activities. Subclause 18(4) excludes from starting base expenditure acquired exploration expenditure. However, subclause 19(1) qualifies this by providing that the person holding the interest is taken to have an acquired exploration expenditure amount equal to the acquisition expenditure allocated to exploration assets and evaluation assets, as recorded in a financial report that satisfies subclause (2). Subclause 2 provides, in essence, that the financial report must have been prepared in accordance with proper accounting standards.

Subclause 18(6) deals with interests acquired before 30 June 2007. Subclause 18(6) excludes from eligible real expenditure the cost of interests acquired before 30 June 2007 whether the interest was acquired by a person or company.

The look-back approach is modified in another way in addition to the acquisition provisions:

The look-back approach is also modified so that only expenditure incurred after the date of acquisition, that would have been deductible if the PRRT had applied, can be applied against assessable receipts derived after 1 July 2012 [Schedule 4, item 11, subsections 45(2) and (5)]. This is in contrast to the general look-back approach where expenditure incurred after 1 July 2002 can potentially be taken into account.

Part 2—Other amendments

Item 25 inserts proposed section 4A which deals with when a person is deemed to have an interest in a petroleum project. The criterion that applies to petroleum projects generally, combined projects, and to the Bass Strait and the North West Shelf is: is the person entitled to receive receipts from the sale of petroleum, or marketable petroleum commodities? If the person was so entitled, that person is deemed to have held an interest. This criterion also applies to exploration permits (proposed section 4B) and retention leases (proposed section 4C). These definitions appear to

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34. Ibid., paragraph, 5.101, p. 87.
35. Ibid., paragraph 5.109, p. 89.

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Under the PRRT, exploration expenditure is transferable from one project to another. If notional assessable receipts equal or exceed notional deductible expenditures, exploration expenditures are generally transferable. Item 50 adds to Part 1A of the PRRTAA 1987 proposed section 4C. This provides that exploration expenditure incurred before 1 July 2012 for onshore projects or the North West Shelf is not transferable. According to the Explanatory Memorandum:

> Exploration expenditure incurred by a person holding an interest in an onshore project or the North West Shelf project prior to 1 July 2012 as a result of them choosing the look-back approach is non-transferable. [Schedule 4, items 49 and 50]

This reflects the policy intent of providing only those project interests that existed as at 2 May 2010 with a tax shield in recognition of the investment that occurred prior to the announcement of the extension of the PRRT. 36

**Schedule 5—Consolidated groups**

**Part 1—Main amendments**

The Policy Transition Group’s recommendation five for the MRRT was that a group that is consolidated for income tax purposes should also be allowed to elect to be treated as a single entity for MRRT purposes. 37 The Policy Transition Group did not make a similar recommendation for the PRRT. However:

> ... the provisions in Schedule 5 to the Petroleum Resource Rent Tax Assessment Amendment Bill 2011 (Main Bill) ... amend the Petroleum Resource Rent Tax Assessment Amendment Act 1987 (PRRTAA 1987) to provide for certain groups of entities that have formed a consolidated group for income tax purposes to also choose to consolidate for Petroleum Resource Rent Tax (PRRT) purposes. 38

**Item 1** inserts proposed section 58N which grants the head company of a consolidated group (or multiple entry consolidated group) the right to choose to consolidate.

Whereas there are relatively few taxpayers involved in onshore projects, there are more participants in offshore projects. Accordingly:

> ... the PRRT law is amended to allow a corporate group with multiple interests in an onshore project to consolidate those interests into a single entity. 39

**Item 1** does this by inserting proposed section 58P which provides, among other things, that a subsidiary of a consolidated group is taken to be part of the head company (or provisional head company of the group), rather than a separate person (proposed subsection 58P(1)).

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36. Ibid., paragraph(s) 5.130 and 5.131, p. 95.
37. Policy Transition Group, op. cit., p. 19.
39. Ibid., paragraph 6.10, p. 98.

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While interests in onshore projects are deemed to be vested in the head office (proposed section 58Q):

... the members of the group will be jointly and severally liable for paying the head company’s PRRT liabilities if the head company does not pay them. ⁴⁰

When a head company is taken over by a new head company, the new head company is deemed to have assumed everything that happened in relation to the old head company (proposed paragraph 58U(1)(b)).

The Explanatory Memorandum explains the other provisions adequately.

Part 2—Other amendments


Items 2 and 3 respectively add notes to subsections 703-50(1) and 719-50(1) of the Income tax Assessment Act 1997 to the effect that a group that is consolidated for income tax purposes may also consolidate for the purposes of the Petroleum Resource Rent Tax Assessment Act 1987.

Schedule 6—Other amendments

Part 1—Amendments related to clean energy package

Item 1 amends the PRRTAA 1987 by including in a project’s assessable miscellaneous receipts amounts derived from the sale of carbon units, issued under the Clean Energy Act 2011, are received free under the Jobs and Competitiveness Program, and that relate to the project. The Explanatory Memorandum contains the reasons for this provision in paragraphs 7.3 to 7.6. ⁴¹ Note that the reference to ‘subsequent sale’ in paragraph 7.6 refers to emission units sold after the first three years of operation of the clean energy package. Where a body fails to meet its obligations under the Clean Energy Act 2011 and so incurs a unit shortfall charge, this expense will not be deductible (item 2).

⁴¹. Ibid., pp. 111-112.

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Part 2—Amendments related to repeal of an Act

Item 3 repeals the Petroleum Resource Rent Tax Act 1987.\textsuperscript{42} Note that under the ‘commencement’ clause, this will not come into effect until 1 July 2012.

Item 5 is a transitional measure to the effect that any payments made are deemed to discharge liability to pay tax imposed by the three imposition Bills.\textsuperscript{43}

Part 3—Other amendments

Excise applies to crude oil and condensate produced in coastal waters, onshore areas and the North West Shelf. Under the Bill, excise will continue to apply in areas to which the PRRT will extend:

The existing crude oil excise arrangements are not intended to be disturbed by the extension of the PRRT to all Australian oil and gas projects from 1 July 2012. These arrangements will continue to apply once the projects become subject to the PRRT, with the excise paid being creditable against the PRRT.

To ensure this outcome, the definition of ‘Resource Rent Tax area’ in subsection 3(1) of the Excise Tariff Act 1921 has been amended to exclude any onshore oil and gas project area, in addition to the existing exclusion applied to the North West Shelf exploration permits \textit{[Schedule 6, item 7].}

This will mean that the onshore oil and gas projects liable to pay the PRRT will continue to be subject to the excise regime. This amendment merely maintains the status quo under the Excise Tariff Act 1921.\textsuperscript{44}

Concluding comments

The Bill provides a single national framework for the taxation of petroleum production. This is consistent with the Policy Transition Group’s recommendation 72 that, in general, the PRRT should apply to all onshore and offshore oil and gas extraction projects, including coal seam methane and oil shale projects.\textsuperscript{45}

The Bill extends the Commonwealth’s power—yet again—into an area traditionally the preserve of the states and is another example of a seemingly inexorable trend towards the consolidation of financial power in the Commonwealth even though, constitutionally, responsibility for major functions—such as health and education—traditionally belong to the states. In short, vertical fiscal


\textsuperscript{43} Ibid., paragraph 7.10, p. 112.

\textsuperscript{44} Ibid., paragraph(s) 7.12-7.15, p. 113.

\textsuperscript{45} Policy Transition Group, op. cit., p. 169.

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imbalance—already extreme by the standards of other federal systems—will become even more extreme.

The Bill proposes that resource tax expenditure be deducted from assessable receipts when calculating PRRT liability. This provides an incentive to the states and territories to impose royalties on petroleum production. As the Policy Transition Group observed in recommendation 90:

> It is important to ensure that the taxation of Australia’s petroleum resources preserves our international competitiveness and ensures Australians receive a greater benefit from these resources and that this is reflected in the treatment of royalties under the PRRT. The extension of the PRRT should not be used as a mechanism to enable States and Territories to increase inefficient royalties on petroleum activities. All current and future resource taxes on petroleum should, therefore, be credited and it is imperative that the Australian, State and Territory Governments put in place arrangements to ensure that the States and Territories do not have an incentive to increase royalties. 46

This may be wishful thinking. Based on the expectation that the mining resource rent tax will allow deductibility of state mineral royalties, some states have moved to increase mining royalty rates. 47

For example, Western Australia, in the 2011-12 Budget, announced that it intends to remove concessional iron ore rates, and increase the rate on fine ore to the higher rate applying to lump iron ore. At this stage it is not clear to what extent the states plan to introduce royalties on petroleum projects although Queensland is talking about annual royalties of $750 million from natural gas. 48

The Commonwealth currently pays some royalties to Western Australia:

> The Commonwealth provides general revenue assistance to Western Australia from royalties collected under the Offshore Petroleum (Royalty) Act 2006 in respect of the North West Shelf oil and gas project off the coast of Western Australia. The Commonwealth collects these royalties because it has jurisdiction over offshore areas.

> These royalties are shared between the Commonwealth (approximately one-third) and Western Australia (approximately two-thirds). These payment arrangements are in accordance with the revenue sharing arrangements in section 75 of the Offshore Petroleum and Greenhouse Gas Act 2006. 49

The Commonwealth also:

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46. Ibid., p. 174.
47. For example, Western Australia, in the 2011-12 Budget, announced that it intends to remove concessional iron ore rates, and increase the rate on fine ore to the higher rate applying to lump iron ore. See Western Australia, Budget paper no. 1: 2011-12, Department of Treasury and Finance, Perth, 2011, p. 12, viewed 23 November 2011, [http://www.treasury.wa.gov.au/cms/uploadedFiles/State_Budget/Budget_2011_12/Budget_2011_12_bp1_budget_speech.pdf](http://www.treasury.wa.gov.au/cms/uploadedFiles/State_Budget/Budget_2011_12/Budget_2011_12_bp1_budget_speech.pdf)

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... provides general revenue assistance to compensate Western Australia for the loss of royalty revenue resulting from the removal of the exemption of condensate from crude oil excise in the 2009-10 Budget.\textsuperscript{50}

It is not known if these arrangements will change.

As it is currently structured, the PRRT distorts economic incentives. In a paper prepared in 2003 for the then Department of Industry, Tourism and Resources, Hogan argued:

The key issue in the current fiscal settings of Australia’s petroleum resource rent tax is the economic incentives resulting from the current settings of the threshold rate for different expenditure categories — all of these rates vary from the long term government bond rate. Most importantly, the current system results in economic incentives to underinvest in higher risk wildcat exploration (although the signals are mixed for new investors), and to overinvest in the development phase (that is, overinvest in infrastructure for a given level of output) to take advantage of an annual rate of return that is significantly in excess of the long term bond rate.\textsuperscript{51}

Hogan proposed two options to remove this distortion. Key features of Hogan’s preferred approach are:

- all exploration and general project expenditures are accumulated at the long term government bond rate;
- all exploration and general project expenditures receive a 100 per cent tax deduction; and
- the tax rate is reduced from its current level of 40 per cent to a level that ensures the government does not increase its share of the industry’s economic rent (assuming revenue neutrality, or the current share, is an appropriate and approximate benchmark).\textsuperscript{52}

These proposals have not been acted upon and the Bill does not address these distortions.

As discussed above, Part 2 of Schedule 4 of the Bill inserts provisions relating to incurring and transfer of exploration expenditure on or after 1 July 1990. The Institute of Chartered Accountants has been critical of retrospective tax laws in general, and the proposal to amend retrospectively the PRRT back to 1990 in particular:

The government is now pursuing three important retrospective changes to the tax law to plug revenue shortfalls that would potentially derail their ambitions of realising a budget surplus in 2013.

The first change relates to a government announcement made in May as part of the budget that it would retrospectively amend the petroleum resource rent tax (PRRT) law 21 years, back to 1990. The explanation was that this change would clarify the application of the law for all parties involved in complying with the PRRT regime.

\textsuperscript{50} Ibid.

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The problem with this line is that there has been a major litigation running for a number of years on the very issue the government is supposedly stepping in to clarify.

If a major litigation has been running for that time, many would wonder precisely how clear the legislation was to start with.

By making this retrospective change, the government has effectively ended taxpayers' rights to contest their view of the law in court. 53

52. Ibid., p. 5.
http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id%3A%22media%2Fpressclp%2F1257338%22

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