

THE TAXATION REGIME AND GOVERNMENT POLICY RELATING TO ITS PARTICIPATION IN EXPLORATION

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The tax regime currently allows for almost all forms of exploration expenditure to be deducted against any form of assessable income received by the explorer. Development expenditure is currently amortised over a period of five years commencing from the date of expenditure. The proceeds of sale of exploration assets are treated as assessable income as are all forms of production receipts.

The Crown levies a royalty of between 10 and 12.5 percent of the well-head value of petroleum receipts.

The entire petroleum taxation regime is under review. A bill was introduced to Parliament during 1988 that would have involved radical changes to the taxation of petroleum exploration and production activities. In the face of sustained industry opposition and criticism the bill was withdrawn. No new policy or proposals have been announced yet but government statements have been made to the effect that new rules are intended to be in place from 1 October 1989.

The Government has commenced a wide ranging review of resource law statutes and various resource rent regimes have been suggested. Government policy in this area is still in a state of flux.

The Crown takes part in exploration by usually acquiring a non-contributing 11 percent but nevertheless fully participating interest in most prospecting licences. The Crown generally seeks to obtain full commercial advantage from such participation.

INTRODUCTION

The subject matter of this paper is very broad and it is neither possible nor appropriate to deal with all of the specific legal or financial aspects of the taxation regime or all the nuances and implications of government exploration policy.

This paper will summarise the broad effects and purpose of the current taxation regime as it presently exists, will comment upon the history of the various reform proposals and will bring conference participants up to date with the most recent proposals.

The latter part of the paper is devoted to a discussion of government policy relating to oil exploration. The central difficulty with this part of the paper is that government policy is not recorded in any legislation or regulation but can only be gleaned from official publications, from decisions made by officials and the Minister from time to time and by reference to various Ministerial statements. As is mentioned below petroleum is a highly political subject and as a result government policy can be expected to and quite frequently does change.

THE TAXATION REGIME

Introduction

Various of the then current issues relating to the taxation of petroleum companies were canvassed in a paper by the writer to the Energy and Natural Resources Law Association. Since the date of delivery of that paper (November 1988) very little has changed except that the most recent proposals of the Government have now been put forward for discussion. Accordingly, in this paper it is intended to summarise part of the content of the earlier paper and to summarise the most recent proposals for reform.

The existing regime

The legislation for the taxation of petroleum mining companies is to a large extent a code of its own and in its present form can be found in Sections 214A to 214C of the Income Tax Act 1976. The regime is complex but it can be reduced to the following essential characteristics:

- (a) All forms of exploration expenditure, including costs relating to the acquisition of licences, are deductible against the assessable income of the relevant petroleum mining company.
- (b) Expenditure associated with the development of a discovery is deductible over a five year period. Remote mining properties (being properties more than

ten kilometres off shore or in more than 50 metres of water) can commence claiming that deduction in the year the expenditure is incurred but for other mining locations the deduction can be taken the year when commercial production first commences or could have commenced. The definition of development expenditure is very wide and covers almost any cost related to that development.

- (c) A company holding shares in a petroleum mining company can deduct payments to that petroleum mining company if the payments are used for exploration or development purposes.
- (d) Any sale of a licence or other receipt of money for which a deduction had previously been obtained will be treated as assessable income.

In essence, at the exploration stage, there are no capital items and almost all forms of exploration expenditure are deductible. The corollary is equally true, namely that virtually all receipts will be treated as assessable income.

At the development stage all expenditure is depreciated over five years irrespective of the nature of the asset or the expected life of the relevant development.

The reform process

The present regime has been in place for many years. It has seldom been the subject of litigation and has been relatively easy to apply in practice. Nevertheless there has been a widespread (and in the opinion of the writer, erroneous) perception that the regime is concessionary and that reform of the taxation of petroleum mining companies was long overdue. The reformation process commenced in January 1987 and the debate has since continued as between officials from the New Zealand Treasury Department and petroleum industry representatives.

The objective of the reform has been to create a taxation environment that is *neutral*. This means it is intended that the tax treatment for petroleum exploration and production be no different to the treatment of any other industries. As will be seen, this has proved a somewhat elusive concept and has been extremely difficult to put into practice.

The tax reform process has now taken four stages:

- (a) The publication in January 1987 of the Consultative Document on proposals for the reform of petroleum mining taxation and various Industry submissions in response to that document.
- (b) Annex 4 of the 17 December 1987 Government Economic Statement which detailed provisions for a review of petroleum mining taxation.
- (c) Industry submissions to the Taxation Reform (No. 4) Bill, the withdrawal from the Bill of the provisions relating to petroleum taxation and subsequent proposals and discussions.
- (d) The most recent proposals of Treasury officials for a taxation regime.

The Consultative Document

The Consultative Document was a discussion piece about various proposals for the reform of petroleum mining taxation and contained some of the philosophy regarding future legislation.

There were a number of key proposals.

- (a) Costs associated with the drilling of a well to be written

off in the year the well is sealed and abandoned.

- (b) Expenditure on the acquisition and processing of seismic data directly relating to a well to be written off when the well is sealed and abandoned.
- (c) General exploration expenditure relating to a licence, including licence acquisition costs to be deductible in the year the licence is abandoned.
- (d) Development expenditure to be amortised over the expected life of the field to which the development related.

The response of various industry participants contained a number of common themes namely:

- (a) The Industry was generally supportive of the move towards a *neutral* basis of taxation.
- (b) The Industry strenuously argued that the reform of the taxation of petroleum mining companies should form part of an overall review of energy policy.

In retrospect the Consultative Document can be seen as very much a preliminary analysis by both officials and the Industry of the petroleum taxation regime. Both the content of the document and Industry responses showed little understanding by either party of the objectives and constraints of the other.

The economic statement

In December 1987 the Government released a major economic statement which will be remembered by those in the petroleum industry for Annex 4 which contained the *conclusions* of the Government as to the basis for reform. One of the objectives of the new regime was to *encourage petroleum exploration companies to make investment decisions based more on commercial considerations rather than tax*.

The main reforms proposed were:

- (a) All expenditure on exploration wells to be deducted on a straight line basis over a period of ten years irrespective of the success or failure of the relevant well or the length of relevant licence or otherwise.
- (b) Licence acquisition costs to be accumulated in a cost field account and only written off when the licence was relinquished.
- (c) Other forms of exploration expenditure relating to information acquisition to be amortised over the period between the expenditure being incurred and the time when the information obtained as a result of that expenditure is required to be placed in the public domain.
- (d) Development expenditure to be depreciated over the expected life of the field or at the rates applying to assets in other industries. All such deductions to commence in the year commercial production first commences.

Not surprisingly, the Industry reacted quickly and with some hostility. The proposal to require exploration costs associated with the drilling of a well to be amortised on a straight line basis over ten years caused the most controversy. The Industry was able to make a unified response and made lengthy submissions to the Parliamentary Select Committee considering the Bill introduced to enact the various reforms.

The Industry submissions concentrated on the following aspects:

- (a) The ten year amortisation period for expenditure on exploration wells was attacked as being arbitrary and

not tax neutral.

- (b) The proposal that development expenditure be amortised over the expected life of the field was also attacked because of its considerable uncertainty. This criticism was directed largely at the practical ability of the legislation to be implemented. Specifically the industry submitted that it would always be a matter of guess work as to the expected life of any field and that amortisation on this basis would not represent good taxation policy.
- (c) The various provisions in the legislation relating to the cost of acquisition of licences, transfer of licences and deductibility of the costs associated with both were considered as being excessively complicated and largely unworkable. By way of comment the legislation in this area is virtually incomprehensible until read and analysed several times and even after such an analysis there still remains confusion and no little doubt as to how some of the provisions were expected to work in practice.

The Industry also put forward detailed proposals as to a legislative framework which the Industry would accept and which it felt would substantially meet government requirements.

There was considerable debate and discussion in the days and weeks following the Industry's submissions to the Select Committee. Somewhat abruptly the Industry was informed that the Bill had been withdrawn and the result is that for the present the taxation regime summarised at the beginning of this paper remains the law.

Current status of proposed reform

The Industry was informed that a new regime would be in place by 1 October 1989. This is now an impossible deadline and the most recent position is that the deadline has been extended. Treasury officials on 10 August 1989 circulated a discussion document with the most recent proposals for a petroleum new taxation regime. The main ingredients of the new proposal are as follows:

- (a) Development expenditure to be amortised over a period of ten years (the commencement date for such amortisation has been left open).
- (b) All seismic and information acquisition costs will be required to be capitalised to a cost of licence account and deductible either on the relinquishment of the licence or over a period of ten years from the date of first commercial production from within that licence.
- (c) The cost of exploration wells will be deductible once the relevant well has been sealed and abandoned and the explorer has filed a statutory declaration stating that it has no intention of utilising the well or of applying for a mining licence based upon any deposit of petroleum discovered in the well.
- (d) Farm-outs will be taxed in an entirely new fashion. Any disproportionate expenditure incurred by a party farming-in will be capitalised to a cost of licence account while the party farming-out will be treated as having received the same amount by way of assessable income.

The essential objective of the regime remains the same; namely, to tax investments in petroleum mining more neutrally relative to investment in other sectors. The difficulties

of applying a strictly neutral tax regime to riskier investments such as petroleum exploration are acknowledged but government officials have suggested that the regime briefly summarised above will still result in investors in petroleum mining facing effective tax rates significantly lower than those faced by investors in most other sectors of the economy.

The Industry is currently formulating a response and marshalling its arguments. The Industry will take up the challenge of debating all of the financial and economic issues raised by the new policy suggestions.

Of the new policy proposals by far the most controversial will be the proposed treatment of farm-outs. By way of illustration, in the archetypal farm-out, a party holding 100% of a licence will farm out 50% of its interest to a party prepared to incur the costs of drilling a well. If the well is dry and is then sealed and abandoned, the party farming-in will be able to deduct immediately 50% of the costs it incurred with the other 50% capitalised to a cost of licence account and only deductible once the licence is relinquished. For the party farming-out it will be deemed to have received assessable income in an amount equal to 50% of the costs of drilling the well. Tax at the rate of 33% will be payable on that amount. However, as I believe everyone in the exploration industry would understand and appreciate, the party farming-out has received no income in any normal or accounting sense and certainly does not necessarily have a net increase in wealth with which to pay any tax. The Industry is alarmed about this aspect of the proposal because it demonstrates a fundamental misconception about the financial and economic effects of standard Industry practice. The Industry feels obligated to record its disappointment that after all of the dialogue on the subject of taxation reform, such a radical and ill-conceived proposal should still see the light of day.

The process of the debate has been characterised, especially at the early stages, by a good deal of misunderstanding by both sides as to the objectives and requirements of the other. The Industry has accused Treasury of not understanding the special characteristics of the petroleum exploration and mining industry and the importance of that industry to the national economy. The response of Treasury officials has been the same as to that of many other lobby groups throughout New Zealand also claiming special or unique attributes and also claiming their importance to the national economy.

On the other hand, Treasury officials have no doubt felt a keen sense of frustration at the failure of the Industry to comprehend the economic rationale and logic behind the various reforms proposed. Treasury has consistently pursued a unified economic theory for all industries which in theory attempts to tax all industries on a neutral basis. This economic argument was however not drawn out or featured in the Consultative Document or economic statement and was only late in the debate promulgated or expanded upon in any form. As a result of the late appreciation by the Industry of the importance of the economic issues the Industry engaged leading economists to prepare its responses to ensure that the Industry submissions are presented in the same language as that used by Treasury officials.

Conclusion

The conclusion from the foregoing is that it is not possible to make a satisfactory prognosis as to the future taxation regime that will apply in New Zealand. We can state with certainty that the current regime is that initially outlined, but it is not possible to state for how long that regime will be in force. Certainly it is the expectation of officials and the Industry that the new regime (whatever it is) will be in force as from 1 April 1990. What is far less certain is the economic effect of that new regime and the impact it may have on future investment decisions. Only time will tell.

GOVERNMENT POLICY TOWARDS PETROLEUM EXPLORATION

Introduction

The taxation of petroleum mining companies is invariably a controversial subject. Equally controversial are the various aspects of government policy relating to petroleum activity.

Petroleum exploitation is an intensely political subject, not just in New Zealand but in almost every nation around the world. The politics of energy is an area that is invariably the subject of considerable debate. The focus of the debate is the method by which the bounty of nature is to be divided as between the risk-takers and managers (the oil companies) and the owners of the resource (the nation).

In this context New Zealand is no different from other nations. However, New Zealand is relatively new to petroleum exploration. There are only four developed fields (Kapuni, Maui, McKee and Kaimiro) and all of those fields have their own special characteristics. It is only in the last decade that petroleum exploration activity has become more wide spread and that has created the need for a more closely defined government policy relating to government participation in exploration.

This paper will summarise the main features of current government policy, briefly record the historical background of the current policy and will offer some comment on some of the live issues presently the subject of much discussion.

Current policy

It is not intended to summarise the relevant provisions of the Petroleum Act or Petroleum Regulations. This is being dealt with by others. Rather it is intended to review those aspects of policy that are not the subject of legislation or regulation and which can be changed at any time.

Before discussing government policy it is important to appreciate that in the New Zealand context there is no private ownership of petroleum. Private ownership of petroleum will only arise after oil or gas has been recovered to the surface pursuant to mining operations conducted by a licensee. Only the government has the right to grant licences. The Crown can grant those licences to private interests or to itself. The policy guidelines as to when and in what circumstances a licence will be granted are not specified. There are various provisions in the Petroleum Act that contemplate licences being declined or development programmes amended if the Minister of Energy considers that to do so would be in the *national interest*. The national interest is not defined.

The Government therefore has very wide powers and discretions that are exercised on behalf of the Crown and which relate to all aspects of petroleum exploration and development. The general objective of government policy is to ensure that the nation receives the wide ranging benefits that can flow from a successful exploration regime. The Crown endeavours to take those benefits through the ordinary incidence of taxation, by way of direct participation, through the receipt of royalties and other means. The overall policy objective is presently pursued in two main ways:

- (a) The Crown claims a royalty on the selling value of all petroleum produced in a licence which royalty is set at a rate determined and provided for in the licence document at the time the licence is granted. The rate that is currently applied to all new licences is 12.5%.
- (b) The Government includes as a condition of the licences it grants, a provision whereby the Minister of Energy becomes entitled to an 11% interest in the licence but with no obligation to contribute to any exploration expenditure. This is set out in the Ministry of Energy Publication, *Petroleum Exploration in New Zealand News*:

The non-contributory nature of the interest remains only until a mining licence is granted in the event of a discovery. From that time the Minister of Energy contributes 11% of the development costs in return for 11% of the revenues from production.

By virtue of a Ministerial statement made early in 1988 current government policy is that the Crown will not sell or assign its free carried or non-contributory interest to any other party.

Within the above constraints the Government generally seeks to do what it can to promote and encourage exploration in New Zealand. To this end the Ministry of Energy has through its officials energetically promoted the prospectivity of New Zealand in many parts of the world. There has been an enormous increase in petroleum activity in New Zealand over the last ten years which can be in part attributed to the success of various government policy initiatives but is in no small measure also attributable to the increasing realisation that New Zealand is both prospective and under-explored.

Historical background

The modern era of exploration dates from the discovery of Kapuni gas field in the on-shore region of Taranaki. By far the most significant event for the petroleum exploration industry and government policy towards exploration was the discovery in 1969 of the Maui gas field. In order to encourage the Maui joint venturers to develop that discovery the Government entered into a long term take or pay contract for gas production from the field and also took up a 50% interest in the field itself. This event represented the beginning of active government participation in petroleum activities.

In 1975 the Government decided to participate in exploration joint ventures. Participation in exploration was regarded as being in the nation's best interests for a number of reasons including providing a mechanism by which the Crown could:

- (a) Fulfil its resource management role.
- (b) Effectively monitor exploration and development activity.
- (c) Obtain information.
- (d) Acquire experience and knowledge about the industry in New Zealand with a view to using that knowledge to develop better policies.
- (e) Maximise its share of any benefits accruing from exploration.

In 1978 the Government formed Petrocorp as its vehicle for petroleum exploration and by 1979 Petrocorp had become the vehicle for all Crown exploration activities. Thereafter government policy was to actively promote exploration. In order to secure a share of the potential benefits of exploration Petrocorp acquired a 51% interest in almost all new licences but with only an obligation to contribute to 40% of the costs of exploration. This policy became somewhat watered down over time and eventually the Government resolved to dispose of the Crown's interest in Petrocorp. The curtailment of the Crown's active participation was brought about for a number of factors including:

- (a) The initial government objective of promoting exploration in New Zealand was largely achieved as is demonstrated by the many foreign and domestic companies actively involved in the industry today.
- (b) Financial constraints on all government activities.
- (c) A developing philosophical view that the Crown should not generally be involved in any commercial activity.

The policy now in place essentially represents the residue of a much more active participation by the Crown in exploration activities.

The most recent developments in government policy have been the efforts by the Government to dispose of its participation in various fields. Pursuant to this policy the government in 1987 disposed of its interest in the McKee and Kaimiro oil and gas fields. Currently the Crown is pursuing efforts to dispose of its interest in the Tariki and Ahuroa gas fields and the Waihapa and Ngaere petroleum mining licences.

Current Issues

From the foregoing it can be seen that current government policy is relatively simple to state. In practice a number of issues arise. In this part of the paper some of those live issues are discussed. This is by way of illustration and is not necessarily a complete list. Various industry participants may know of other areas of discussion or difference.

The first, and potentially very significant issue, is the reconciliation of the Minister's regulatory role pursuant to the Petroleum Act and Petroleum Regulations and its increasingly active participatory role in exploration joint ventures. There are no clearly promulgated guidelines as to how this conflicting role is dealt with in practice and it has often led to some confusion and difficulty and not a little suspicion. For the most part the Ministry officials actively involved in the monitoring of government participation are distinct from the officials involved in the regulatory role. However, New Zealand is a small place, the petroleum division of the Ministry of Energy is a small division and there is not much industry confidence in any

Chinese Walls that may or may not exist within the Ministry of Energy.

A second live issue relates to the nature and extent of the Crown's right and ability to influence and affect exploration decisions within a joint venture when the Crown is not spending any of the money associated with such activity or decision. Those who argue that the Crown should not have any rights characterise the discussion with the epithet *no pay - no say*. The Crown contend that a non-contributory interest is nevertheless a fully participating interest and as such the Crown ought to have full voting rights. This issue is still to be resolved.

A third issue relates to the precise date when the Crown's participation in a licence becomes a contributing interest. The policy statement referred to above states, and the licence documents issued by the Ministry of Energy usually state, that the switch to a contributing interest takes place when a mining licence is granted. However, in various discussions concerning this issue Ministry officials assert that government policy as to the date when their interest becomes contributory is the date when a decision is made to develop the discovery even if a mining licence had previously been issued in respect of that discovery. This effectively delays the commencement of Crown contributions and obviously is a matter of concern for non-Crown participants. The substance of this aspect of the Crown contention is that the Crown is not to be exposed to any exploration risk and will only become a paying participant when a discovery is to be developed with the underlying assumption that that development will be economic. The Crown is therefore an exceedingly risk averse joint venturer.

The fourth issue relates to the change from government participation as administrator and promoter of petroleum exploration activities to that of owner of all the nation's petroleum resources and the vigorous assertion of all of the ordinary rights of ownership. The initial objective behind the Crown assuming ownership of petroleum was to ease administrative difficulties associated with the licensing process. The Crown is now very concerned to obtain maximum commercial advantage from such ownership. The change occurred gradually, almost without being noticed, but it is a fundamental shift that has important consequences for all parties dealing with the Government in this area. The assertion of ownership of all petroleum resources, the stated aim of obtaining maximum economic return from such ownership and the dependence of all private interests seeking to pursue exploration activities upon the extensive discretions in favour of the Government combine to create an atmosphere of some uncertainty that is not healthy.

It is hoped that a vigorous discussion of these issues will clarify the policy guidelines that ought to be in place when the extensive discretions are exercised.

Conclusion

In conclusion it can be said that the broad principles of current government policy relating to petroleum exploration are straight forward and quite simply stated. There are difficulties and disagreements as to the precise application of that policy and in this regard some in the industry may feel that relevant policy is made up as events arise. This should

not be regarded as in any way unusual. Many aspects of government policy in many areas of government activity are the subject of ad hoc decisions and change. As stated at the outset of this paper, petroleum is often an actively debated and political subject. It is therefore scarcely surprising that

government exploration policy will often change. That said, however, the exploration industry would be more reassured if the policy was more explicitly disclosed and not the subject of interpretation by government officials as problems arise.