

# Fiscal initiatives – future directions

## S Smith and G Nightingale

*Tax Director, KPMG, PO Box 996, Wellington, New Zealand, DDI 64 4 802 1740,  
Email: SpencerSmith@kpmg.co.nz*

*Tax Director, Ernst & Young Ltd, PO Box 490, Wellington, New Zealand, DDI 64 4 470 0519,  
Email: geof.nightingale@nz.ey.com*

## Abstract

In 2004 the Government introduced a package of initiatives including changes to fiscal terms aimed to encourage gas exploration in New Zealand.

These fiscal initiatives were introduced against the backdrop of a fiscal regime of petroleum exploration and development that the Government considers is already quite competitive in world terms.

The paper considers the following questions:

- What were those initiatives and in what context was the package developed?
- For what reason did the Government settle on the initiatives implemented and why were other proposals discarded?
- Do the measures achieve their intended effect?
- What remains to be done and what further areas could be developed?
- From an industry perspective what are the tax policy and other policy settings of the Government that need to be taken into account in considering further measures?

As such, under current policy settings, what more might be achievable ?

**Keywords:** *fiscal, initiatives, government, policy, tax, royalty, intervention, PEPANZ, losses, amortisation*

## Introduction

At the time of writing this paper, the problem of replacing Maui's historically enormous gas reserves looms as large as ever.

To make matters worse for New Zealand, the price of oil has jumped markedly which has put further pressure on New Zealand's balance of payments. As the New Zealand dollar inevitably weakens, the problem will become worse.

Therefore a significant gas or oil discovery would be most welcome.

New Zealand already faces fierce competition for investment in exploration. However, the cost of investment has just got higher with the demand for rigs, equipment and experienced crews being pushed by the increasing price of oil and the rush to repair the hurricane damage in Gulf of Mexico. New Zealand already has a good fiscal regime, but maybe it has to be better than good if it is going to get the investment that is now so urgently required.

In this paper, we consider possible initiatives the New Zealand Government could usefully take to improve the fiscal framework for petroleum explorers and developers.

## The 2004 Package

Any Government intervention must be carefully considered in terms of the cost and benefits. An increase in oil and gas prices may do much more to attract investment than any fiscal tinkering. In this regard, the 2004 gas exploration incentive package is an interesting case study.

At this conference in March 2004, the associate Minister of Energy, Hon. Harry Duynhoven announced that the Government was considering further measures to facilitate greater petroleum exploration to improve indigenous gas supply. Officials from the Ministry of Economic Development (“MED”) were already engaged at that stage in considering what form those measures might take. The work culminated rapidly in an announcement from the Government of a package of gas exploration incentives on 14 June 2004.

The measures announced were for new discoveries during the period from 30 June 2004 to 21 December 2009 (“the initiative period”):

- A reduction in the ad valorem royalty (“AVR”) rate from 5% to 1% for gas only (oil remains at 5%);
- Allowing exploration and prospecting costs from other permit areas as a deduction for the purposes of calculating the accounting profits royalty (“APR”);
- Allowing nominated exploration and prospecting costs in a particular year to be carried forward to be increased by a notional interest component for later deduction when a mining permit is issued;
- Reducing the APR from 20% to 15% on the first \$750m gross sales of petroleum from an offshore discovery or \$250m from an onshore discovery made during the initiative period.

The changes apply only to new discoveries made during the initiative period (see our later comments on this scope).

Further, a specific review of the tax rules was announced in the areas of non-resident drilling operators, the treatment of development expenditure and the application of some parts of the GST law to the sector.

Finally, the Government announced that it would commit \$15m to funding seismic mapping and increased resourcing of Crown Minerals ( and a seismic survey off the east coast of the North Island was completed in May 2005).

The proposed royalty changes were implemented by Government in the new minerals programme effective from 1 January 2005.

The tax policy work has so far resulted in a temporary exemption from New Zealand income tax during the initiative period for non-resident offshore rig operators and (after some valuable input from PEPANZ and industry sources) non-resident development drilling operators and non-resident operators of seismic survey ships.

No further announcements have been made in regard to the tax treatment of development expenditure or the GST issues. However we understand that consideration of these matters remains work in progress for officials and they have not disappeared off the radar.

All up, the proposed package was forecast in 2004 to represent an additional commitment of up to \$100m in gas exploration over the initiative period (including direct spend and estimated forgone royalty and tax revenue).

As result of the relative openness of government in New Zealand, we can, by considering material helpfully published by MED, gain some real insight into the thinking of officials and their advice to Government that resulted in these initiatives. The insights gained can then inform our thinking about what more might be achieved in relation to the industry fiscal settings and how to go about interacting with Government to get it done.

The initiatives targeted gas in particular and, as such, that immediately influenced the design and outcomes. The reason for targeting gas was a particular focus by Government on the economic risks arising from a lack of security of supply of gas for electricity generation. In 2004 the strategic nature of indigenous oil reserves was not considered a strong reason to extend the initiatives beyond gas. It's possible that thinking may have changed by now.

In considering initiatives to encourage more gas exploration officials specifically identified the following design criteria:

- the initiatives must be able to be implemented quickly;
- they must materially improve project economics or reduce exploration and/or production risk;
- they must have low compliance and administration costs;
- with the lowest practical distortionary impact;
- and be consistent with the Government's other policy settings, in particular tax.

The potential impact on project economics of the initiatives under consideration was carefully evaluated by officials. Initiatives were analysed against a base case data set for both onshore and offshore exploration and development projects. The impact of initiatives under consideration was tested in terms of the changes to the net present value of the cashflows. Of course, this analysis was very sensitive to the assumptions contained in the base case and certain key assumptions around the use of tax losses either concurrently or against future project revenues. However, it provided a consistent method for officials to evaluate the likely impact of initiatives on activity levels.

Direct funding participation by the Government either in the exploration and production phase or in the gas industry infrastructure (pipelines, gas purchase agreements etc) was not proposed. Officials were concerned that significant direct investment by the Government in exploration and development was too risky for the Crown. Officials seemed to have some doubt that the lack of Government backed infrastructure investments is a barrier to exploration and there was also a wider concern about the Government crowding out private investment. It is unlikely that officials would generally think any differently today despite some evidence to the contrary (for example, the Government's security of supply risk sharing with Genesis in respect of the e3p power station or the construction of the Whirinaki oil-fired power plant for a dry year reserve).

Royalty changes were preferred by officials as, in addition to meeting these design criteria, they were capable of specific targeting at the petroleum sector thus reducing the potential for unintended outcomes and the policy (and perhaps political) impact of other industries seeking to leverage off the initiatives in pursuit of their own agendas.

Officials were more circumspect on tax changes. They were seen as more a medium to long term initiative, both due to the process involved in achieving the change and the fact that any initiatives were constrained by a firm Government policy not to compromise the integrity of the wider tax system. In addition, the Government already views the petroleum mining tax regime as basically concessionary as compared to the wider tax regime (and this case can be made if overall effective tax rates for petroleum projects are modelled).

The current tax policy setting applied by Government is to apply as lower a rate of taxation as possible in the context of the Government's programme across a broad base where all industries and activities are subject to similar levels of taxation. In terms of this framework, if concessions are provided to one group of taxpayers, the tax burden on others will increase and investment flows will be distorted. The Government's expressed preference is that generally, if it wishes to influence an outcome and it is possible to do so via a non-tax mechanism, then this would typically be preferable to using the tax system. Applying this framework a number of industry proposals for tax reform were considered and disqualified. These included:

- enhanced tax deductibility of industry related expenditure;
- enhanced tax depreciation;
- accelerated drilling incentives;
- monetisation of tax losses;
- shares allowing flow through of underlying tax deductions;
- relaxing shareholder continuity requirements for tax losses; and
- carry-forward of tax losses in real terms (i.e. grossed up for holding costs).

In addition to the policy settings, heavily influencing officials at a practical level was the potential direct and indirect revenue cost of these measures which was considered to be not only high but also difficult to contain and control (once tax concessions are in place historical evidence suggests that taxpayers from outside the intended target industry find ways to access the preference thus increasing the revenue cost of such measures beyond the direct target).

On the other hand, there was strong official support for ensuring that there were no unintended barriers to investment contained in the petroleum tax system. As such, measures focused on removing existing barriers are likely to gain traction with officials (subject to our comments below on the political realities of tax policy process at present).

We don't think that anything has really changed since 2004 in the way that officials think about the tax system so we need to bear that in mind when looking at what's possible.

As to the effectiveness of the 2004 initiatives, it's probably too early to tell and there has been, to our knowledge, no assessment of their impact. However, the recent lack of success in attracting bids for blocks on the Outer Taranaki Basin bidding round, while attributed by commentators to permitting conditions in conjunction with a global shortage of drilling rigs as a result of the hurricanes last year, may also suggest that the fiscal package for new discoveries is not a strong enough factor to overcome other concerns.

## **The Future – What's on or not on the Table**

Although New Zealand is desperately in need of a large gas find, our sense is that Government feels there are limits to what it can usefully do:

- The New Zealand Government has been running surpluses, but it is not confident of sustaining these in a slowing economy.
- Further, the Government made some expensive promises in the 2004 election, which have to be funded somehow.
- Studies undertaken by officials for the 2004 gas incentives programme have shown that seemingly large concessions by Government may sometimes have only a marginal effect on project economics.
- Officials are not particularly inclined to take measures that benefit marginal projects because marginal projects will not solve the looming gas shortage in New Zealand.

However, if the Government takes no further measures, the cost to New Zealand could be very high. To this end it should be striving for a fiscal regime that is better than just good.

In our view, there is still a range of possible taxation and royalty measures that could be implemented, which would have minimal cost to the Government and would underline New Zealand's determination to attract quality exploration companies.

## Tax

Dealing first with tax, the measures that are presently being advocated by the PEPANZ are:

- Preservation of tax losses through shareholder changes
- The elimination of the clawback of exploration well expenditure.
- Immediate deductions for dry or depleted production wells.
- Changes to the amortisation period for development expenditure.
- The addition of oil rig support vessels in the 5 year tax exemption for rigs and seismic survey vessels.

We will briefly discuss each initiative later in this paper.

In our view there are other initiatives that could be added to this list:

- Clarification or elimination of the Onshore/Offshore demarcation.
- Improvements to the PAYE rules for international crews manning offshore rigs.
- Sensible interpretations of a “permanent establishment” in our tax treaties (and sensible treaties to interpret).
- The clarification of GST rules for Joint Venture and Farm-in transactions.
- Statutory entitlement to GST on restoration costs.

We note that we raised each of the last five initiatives at this conference two years ago. Since then, there has been only preliminary work done by Inland Revenue’s Policy Unit in respect of some but not all of these matters.

We have some observations about the political process of getting these changes:

- Inland Revenue has a long list of other things to do with limited resources.
- The confidence and supply support agreements that allow the current Government a majority in Parliament contain commitments to tax policy developments that will consume official’s resources.
- To shift petroleum tax issues further up the list requires influence at the highest levels.
- The chance of success will be improved if the Ministers of Energy and Economic Development are on board.
- That influence must also be assisted with discussions and submissions to officials that show the industry understands the framework of rules and regulations and policy objectives that governs and directs officials’ thinking.<sup>1</sup>
- The Treasury and Inland Revenue still adhere to a neutral tax system as their preferred model and will resist any proposals that may distort that model.
- While the previous two Labour Governments have shown some inclination to intervene in the economy, the third Labour Government has a more delicate coalition balance, a balance which suggests that such measures may be fewer (or at least harder to implement due to the careful support building process required).

These observations are not necessarily shortcomings. One of the benefits of New Zealand’s approach to fiscal policy is that investors are usually given plenty of warning of any changes.<sup>2</sup>

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<sup>1</sup> A simple example is using the right language. The word “incentive” is passé in official circles. “Initiatives” appears to be a better term for the second half of this decade.

<sup>2</sup> It would be highly unlikely that a New Zealand Government of any hue would, without consultation, announce a change such as the Chancellor Gordon Brown’s decision to double the supplementary tax on North Sea oil company profits to 20 per cent.

## Royalties

In relation to royalties, we are aware that Officials are planning a rewrite of the current royalty regime. The purpose of a rewrite is not to change the terms of the regime, but to make the regime clearer with less ambiguity.

The rewrite of the royalty regime is seen by the industry to be an opportune time to reconsider other matters. The industry, through PEPANZ, has mounted a continuing campaign to widen the definition of a “new discovery”. As the present interpretation stands, few (if any) permit holders in Taranaki can expect to benefit from the lower royalties. The industry had understood the Government’s objective was to bring more gas to market from any source and have therefore been disappointed. The Government’s position remains that the incentives were implemented for green-fields projects only.

Other matters that could be considered are the effect of the AVR and the requirement to use market prices rather than hedged prices to calculate the Crown royalty. With the significant swings in oil prices in recent years, some developers might prefer to have the certainty of a royalty directly linked their hedged production income.

## Shifting the Focus - Development

The industry would also like to see Government encouragement for development. Some have suggested the removal of the AVR, which is a further cash outflow before the relevant exploration and development costs have been recovered. However, officials appear to consider any further reduction of the AVR to be pointless:

- The present AVR rates (of 1% or 5%) are considered low and very favourable when compared with other countries.
- Coming off such a low base, the benefit of further cuts would be marginal.
- If a prospect is not worth developing at current prices, then it should not be developed.
- Encouraging marginal projects will not solve New Zealand’s looming gas shortage.

One of the hurdles for developers borrowing funds is that the international lenders are not lending against current prices, nor are they lending against a P50 scenario. There may be a number of good sized prospects in New Zealand that are marginal at the US\$30 barrel/P90 hurdle but are comfortably commercial at current prices on a P50 case.

Is there a case for taking a more imaginative approach? In the view of some, the Government’s approach is too narrow and does not take into consideration the possible national advantages of encouraging development including:

- Substitution of high cost imported oil.
- Partial national self-sufficiency in oil.
- Maintenance and development of the upstream skills base.
- Supplementing future gas volumes for New Zealand’s energy infrastructure.

Crown Minerals are required to obtain a fair financial return for New Zealand’s petroleum. Section 12 of the Crown Minerals Act 1991 states:

12. Purpose of minerals programme-

The purpose of a minerals programme is to establish policies, procedures, and provisions to be applied in respect of the management of any Crown owned mineral that is likely to be the subject of an application for a permit under this Part and, in particular, policies, procedures, and provisions which provide for –

- (a) The efficient allocation of rights in respect of Crown owned minerals; and
- (b) The obtaining by the Crown **of a fair financial return** from its minerals.

Our understanding is that Crown Minerals considers that section 12 mandates a charge for the petroleum whether or not the field is commercially successful, hence the AVR. However, if the Crown offered

a more flexible range of royalty pricing options, could the Crown still claim to be obtaining a fair financial return? We see no reason why not, especially if:

- The Crown could actually increase its royalty take through the development of fields now that may otherwise not be developed now or later;
- It allows the developers and the Crown to take the advantage of high current oil prices;
- Fields are discovered and developed that would otherwise not have been thus contributing to economic activity and general tax revenues.

## **Tax Initiatives – the state of play**

As noted above, PEPANZ has been advocating the following changes:

- Preservation of tax losses through shareholder changes
- The elimination of the clawback of exploration well expenditure.
- Immediate deductions for dry or depleted production wells.
- Changes to the amortisation period for development expenditure.
- The addition of oil rig support vessels in the 5 year tax exemption for rigs and seismic survey vessels.

We will briefly examine the case for each.

### ***Preservation of tax losses***

Officials make no secret of their desire for more medium to large players on the New Zealand exploration scene. However, juniors will still have an important role, particularly if New Zealand's rules allow them to develop and grow. The current tax rules are a significant impediment to growth because they restrict the ability of petroleum companies to bring in new investors without losing their tax losses.

In May 2005, the Government introduced a tax bill that will allow technology companies to defer the recognition of their expenditure to achieve a better match with their future revenue streams. PEPANZ has (quite rightly in our view) asked for a similar rule for the petroleum sector. There is no word from Government yet whether this submission will be accepted.

If it is, one of the things that the industry will have to watch out for is that the rules do not quarantine the deferred deductions. The rules for technology companies will require them to allocate R&D deductions against income resulting from the R&D expenditure. A similar rule for explorers would take exploration losses out of the frying pan and put them into the fire.

### ***Exploration well expenditure claw-back***

Explorers who use an exploration well for subsequent commercial production must add back the well cost and write it off (over 7 years) as development expenditure<sup>3</sup>. PEPANZ wrote to Inland Revenue in November asking for the repeal of this rule. We will not repeat here the reasons advocated by PEPANZ, but our sense is that Inland Revenue will not agree with the case that has been put up.

There may be a second line or argument that receives a more sympathetic response from Inland Revenue. There may be instances where there has been a forfeiture of tax losses and the claw back of well expenditure would not be protected by the tax deductions that were claimed when the exploration well was drilled. In that instance, the developer must pay tax now for future deductions. The extension of the technology company loss preservation rule (in the May 2005 tax bill) to petroleum companies may also provide a partial cure to this problem.

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<sup>3</sup> To our knowledge, the conversion of an exploration well to commercial development is a reasonably rare occurrence.

## ***Dry or depleted production wells***

There is a rule that allows companies to claim a tax deduction for the tax book value of assets that the taxpayer ceases to use but does not dispose of (usually due to the estimated disposition costs relative to likely consideration). There is no equivalent rule where a petroleum miner seals and abandons a dry or depleted production well. While there are arguments that a deduction could be claimed under the current rules, the industry would like any doubt removed. This would ensure consistency with other industries.

At the date of preparing this paper, Inland Revenue has not responded to this submission. However, we consider that Inland Revenue should be sympathetic to this submission.

## ***Amortisation period for development expenditure***

At present, development expenditure is deductible on a straight-line amortisation basis over 7 years, commencing from the year that the expenditure is incurred for an offshore development or from the year of first commercial production for an onshore investment. Inland Revenue considered a shortening the amortisation period to 5 years in 2004 but did not recommend it, presumably because of their wider view that the petroleum tax regime is already relatively generous.

Interestingly, for a hypothetical field with a production life of say 10 years, a shift from a 7 year to a 5 year amortisation period has only a marginal impact on project economics and then only if the project is highly profitable. In the case of a marginal field, the reduction from 7 years to 5 years was only of assistance when resulting tax losses could be offset on a current basis against other taxable income.

A change to 5 years amortisation would have a more material impact on a marginal project with either a shorter life (say 2 to 5 years) or one where the production profile is heavily weighted to the first few years. Or viewed in the inverse, the current fixed 7 year period may result in an economic barrier for shorter life developments.

Inland Revenue are part way through a major review of depreciation of all assets with two rounds of significant changes already legislated or in a bill before Parliament. A third tranche of work continues and in this context Inland Revenue continues to evaluate amortisation rates for development expenditure. Officials are considering an elective amortisation regime based on production profiles which would address the short life development issue. This may well find favour with officials as it would improve the alignment of the amortisation with the economic life of the field, which is the objective of the wider tax depreciation work.

## ***Oil rig support vessels***

The 2004 measures to encourage gas exploration included a 5 year tax exemption for oil rigs (out to 2009). The industry has argued that this should have been extended to non-resident oil rig support vessels. Inland Revenue have disagreed with this submission on the basis that it would give non-residents an advantage over residents. The industry has pointed out that there are no resident suppliers of these vessels.<sup>4</sup> Inland Revenue have concluded that there might be a New Zealand resident owner at some point and, in any case, officials doubt that the problem is sufficiently significant to warrant extension of the tax exemption.

So far, Inland Revenue appears to have been correct in its view of the situation. If the industry says something will be a problem and it turns out not to be one, it could diminish the industry's credibility with officials and consequently the prospects of success for future submissions. Therefore, if any company does become aware of problems with getting oil rig support vessels, we hope it will back up the industry's claim by bringing that problem to the attention of Inland Revenue.

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<sup>4</sup> Some international companies, such as Swire Pacific Offshore have offices in New Zealand, but these offices have representative functions and do not own any ships.

## Conclusion

After the 2004 tax and royalty measures, there is still unfinished business.

The royalty debate will continue as to whether the Crown could or should scrap AVR or alternatively offer flexible royalty options to encourage development.

The tax initiatives mentioned above in this paper are largely practical steps that allow the industry to get on with what it needs to do. The fewer the tax impediments, the more likely New Zealand will attract the investment needed to find the gas it now desperately needs.

It is encouraging that Inland Revenue continues to discuss some of these initiatives with PEPANZ. However, Inland Revenue's job is to collect revenue, not give it away. Consequently, any measure that is not revenue neutral will need the backing of other Government departments (and in particular MED). In other words, a whole-of-Government effort (similar to that required for the 2004 package) may again be required.

For its part, the industry has realised that, if it wants to make any progress on these issues, it needs to be perceived as addressing officials and Ministers in terms of the national interest and not simply through self interest. We also perceive a greater appreciation of the wider relevant policy issues that officials must invariably address in their deliberations. This appreciation will improve dialogue and make it more constructive, but we remain concerned about the speed of progress.

We thank the conference attendees for their time and attention to this paper<sup>5</sup>.

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<sup>5</sup> The views expressed in this paper are personal and are not necessarily those of the writers' respective firms.

## Authors



**Spencer Smith** is a Tax Director with KPMG in Wellington with particular experience in advising foreign owned companies operating in the various resource sectors (electricity, oil & gas, gold, fishing and meat processing). He has been actively involved as an advocate for the mining industry when the current royalty regime was developed, provided input into the 2004 gas exploration package and was involved in preliminary policy development on the now withdrawn carbon tax.



**Geof Nightingale** is a Tax Director with Ernst & Young Ltd in Wellington. He provides tax advice to corporate entities in both the private and the public sector. His industry expertise includes the energy, forestry, transportation and Government sectors. Geof is a member of the National Tax Committee of the New Zealand Institute of Chartered Accountants, a committee which interacts extensively with Government on tax policy developments. He is also an Advisory Board Member of Victoria University's Centre for Accounting Governance and Taxation Research.