DRAFT EXPLANATORY STATEMENT

Issued by authority of the Treasurer

Petroleum Resource Rent Tax Assessment Act 1987

Petroleum Resource Rent Tax Regulations 2024

Section 114 of the *Petroleum Resource Rent Tax Assessment Act 1987* (the Act) provides that the Governor-General may make regulations prescribing matters required or permitted by the Act to be prescribed, or necessary or convenient to be prescribed, for carrying out or giving effect to the Act.

Section 24 of the Act provides that assessable petroleum receipts arising from certain instances of sales gas becoming an excluded commodity in relation to a petroleum project are to be worked out according to the regulation.

The *Petroleum Resource Rent Tax Assessment Regulations 2024* (the 2024 Regulations) reforms the methodology used to calculate the price of sales gas that is processed into liquefied natural gas (LNG), including the advance pricing arrangement (APA) rules, comparable uncontrolled price (CUP) rules and ensuring that tolling arrangements are expressly captured in the regulation. The substantive tolling arrangements relating to Recommendation 8 of the Treasury Review were previously outlined in the *2024 Regulation: Tolling Arrangements* insert, and so will not be dealt with in these draft Regulations.

The amendments in these exposure draft regulations and the exposure draft tolling regulations represent the substantive amendments that will be made as part of the remaking of the *Petroleum Resource Rent Tax Regulation 2015* later in 2024.

On 7 May 2023, the Government announced that it would introduce changes to the Petroleum Resource Rent Tax (PRRT) to deliver a fairer return to the Australian community from their natural resources. The changes respond to the Treasury Gas Transfer Pricing Review (Treasury Review), as well as recommendations in the earlier Callaghan Review. The GTP Review was initiated by the former Coalition Government and restarted under the Albanese Government, and its release follows extensive consultation since 2019. The 2024 Regulations implement recommendations 3, 5, 6, 7, and 11 of the Treasury Review.

The GTP rules are used to determine the arm's length price of sales gas in an LNG project, using one of three methods: the APA, CUP or residual pricing method (RPM). Given that the PRRT is a resource rent tax, the pricing of sales gas under the GTP rules should result in the PRRT taxing those resource rents that are properly attributable to the associated petroleum resource. However, the Callaghan Review concluded that the GTP rules are complex, opaque and raise issues as to whether the outcome ensures the Australian community is receiving an equitable and fair share from the gas used in LNG projects.

The 2024 Regulations aim to mitigate these concerns by updating the CUP rules to be in line with the Organisation for Economic Co-operation and Development (OECD) guidelines, modifying the APA rules to include principles in agreeing to an APA, and

including express rules for tolling arrangements in the RPM calculations. Further amendments to ensure the rent from projects is adequately captured include:

- requiring projects to make an irrevocable election to use the shorter or longer asset life formula;
- equalising the treatment of the notional upstream and downstream entities between loss situations and profit situations; and
- where an LNG facility enters the PRRT regime for the first time for backfill or tolling purposes, the value of the plant for use in PRRT calculations being set to the historical cost of the LNG facility, uplifted by the GDP deflator to the date of first production for PRRT purposes.

The Act does not specify any conditions that need to be satisfied before the power to make the 2024 Regulations may be exercised.

The 2024 Regulations are subject to sunsetting and disallowance.

The 2024 Regulations are a legislative instrument for the purposes of the *Legislation Act 2003*.

The 2024 Regulations commence on the day after their registration.

Details of the 2024 Regulations are set out in Attachment A.

The Office of Impact Analysis (OIA) has been consulted and advised that the Gas Transfer Pricing Review has been certified as a process equivalent to an Impact Analysis. The measure has no impact on compliance costs.

ATTACHMENT A

Details of the *Petroleum Resource Rent Tax Assessment Regulations 2024: Treasury Review Amendments*

This attachment sets out further details on the *Petroleum Resource Rent Tax Assessment Regulations 2024* (the 2024 Regulations). All legislative references are to the 2024 Regulations unless otherwise stated. References to a 'corresponding provision' are to the corresponding provision in the *Petroleum Resource Rent Tax Assessment Regulation 2015* (the 2015 Regulation).

This attachment outlines the principal changes between the 2024 Regulations and the 2015 Regulation that relate to the following matters:

- Advance pricing arrangement (APA).
- Comparable uncontrolled price (CUP).
- Upstream/downstream treatment in profit/loss situations.
- Capital costs for LNG facilities entering the PRRT regime.
- Asset life formula election.
- Technical changes associated with the sunsetting remake.

Part 2 (Section 22) - Advance Pricing Arrangements

Part 2 of Schedule 1 to the 2024 Regulations implements recommendation 7 of the Treasury Review. Recommendation 7 modifies the APA rules to provide guidance to industry and the Commissioner of Taxation (Commissioner) on the principles that the Commissioner must have regard to in agreeing an APA, and to limit the circumstances in which an APA can be entered into.

The APA is an agreement between the Commissioner and a taxpayer that establishes an agreed method to calculate the amount of assessable petroleum receipts for the taxpayer.

The Commissioner may, at the request of a participant in a relevant operation, make an APA with the participant about how the assessable petroleum receipts of the participant are to be calculated in relation to project sales gas.

Section 22 is amended to require the Commissioner to be satisfied of additional criteria in making an APA with a participant of an operation.

The amendments require that the Commissioner must be satisfied that it is not practicable:

- to determine a CUP under section 23 for the project sales gas; and
- to use one or more steps in the residual pricing method (RPM) in relation to the project sales gas for the participant.

The Commissioner must additionally be satisfied that the calculation in the APA will:

- give effect to the RPM;
- result in a reasonably accurate estimation for any RPM steps that are not practicable to use;
- not depart from the RPM statement more than is necessary to address any identified impracticalities in using the RPM;
- not depart from the calculation in section 24; and
- not provide for a capital allowance to be applied to capital costs in a way that is inconsistent with sections 16, 17, 18 or 41A. This requirement has the effect of preventing the Commissioner entering into an APA if it would provide a more favourable outcome than the RPM.

The Commissioner may agree to the term of the APA and is not required to consider the length of any related sales contract when agreeing to the period over which an APA applies. The overarching consideration for the Commissioner is whether the APA gives effect to the RPM.

Where an APA was entered into prior to the amendments to section 22, that APA will remain in effect. This will be the case even where the existing APA could not have been validly entered in to under the amended section 22. However, participants to an existing APA may only amend their existing APA if the APA (as amended) complies with the requirements of section 22.

Part 1 (Section 23) - The Comparable Uncontrolled Price

Part 1 of Schedule 1 to the 2024 Regulations implements recommendation 6 of the Treasury Review. Recommendation 6 updates the CUP rules to align with the Organisation for Economic Co-operation and Development (OECD) guidelines. In particular, the analysis for the CUP should be broadened to consider all reasonable conditions of a comparable transaction. Reasonably accurate adjustments would continue to be permitted.

Section 23 is amended so that:

- inconsistencies between the CUP method in the Regulation and the OECD guidelines are removed; and
- the factors that the Commissioner is required to take into account when assessing a proposed comparable transaction are broadened.

To that end, the term ‘comparable transaction’ is introduced. The Commissioner must now be satisfied, in addition to existing criteria, that a price for sales gas was obtained for a ‘comparable transaction’ and at an arms-length price.

Subsection 23(1) outlines where a comparable uncontrolled price will exist in relation to a relevant transaction. A comparable uncontrolled price in relation to a relevant transaction will exist where the:

- Commissioner is satisfied that the parties to the other transaction were dealing with each other at arm's length;
- other transaction is a comparable transaction to the relevant transaction; and
- other transaction was entered into in a market that the Commissioner is satisfied is a relevant market.

Subsection 23(2) reflects former subsection 23(5) and defines 'relevant transaction'.

Comparable transaction

Subsection 23(3) outlines the factors relevant to determining a 'comparable transaction', which means, in relation to a relevant transaction, another transaction that the Commissioner is satisfied is comparable to the relevant transaction. These factors include the:

- functions performed, assets used, and risks borne by, and business strategies of, the entities involved in both the relevant transaction and the other transaction;
- terms of any relevant contracts between the parties involved in both the relevant transaction and parties to the other transaction;
- characteristics of any property or services transferred; and
- economic circumstances.

Subsection 23(4) allows the Commissioner to make a reasonably accurate adjustment to a price obtained for the transaction to eliminate the effect of any difference between the other transaction and the relevant transaction. To do this, the Commissioner must be satisfied that doing so is necessary to identify a CUP in relation to a relevant transaction.

Subsection 23(5) ensures that the Commissioner does not make adjustments which undermine the arm's length nature of the other transaction, as doing so would undermine the purpose of paragraph 23(1)(a).

Once the adjustment has been made the Commissioner may treat the adjusted price of the other transaction as the CUP to the relevant transaction.

Subsection 23(6) provides that the Commissioner may be satisfied that the other transaction is comparable to the relevant transaction even if the parties to the other transaction dealt with each other at arm's length in relation to the other transaction, but the parties to the relevant transaction did not deal with each other at arm's length in relation to the relevant transaction. This subsection ensures that the mere difference of the arm's length nature of the transactions does not prevent a comparable transaction from being identified.

Relevant market

Subsection 23(7) provides that, in order to be satisfied that the market is relevant (which is a requirement of paragraph 23(1)(a)), the Commissioner must take into account:

- the supply and demand characteristics of the market, including:
  - the composition of the sales gas sold in the market and
  - geographic differences between the production facilities and the product delivery point of the sales gas sold in the market and
  - the end use for the sales gas sold in the market;
- the terms of contracts usual in the market, and conditions reasonably considered to affect the price;
- market strategies;
- spot sales, if they are below or above marginal cost;
- processing costs;
- technology used in processing; and
- any factor that would be reasonable to consider.

<u>Part 3 (Sections 24 and 35) – Upstream/Downstream Treatment in a Profit/Loss Situation</u>

Part 3 of Schedule 1 to the 2024 Regulations implements recommendation 5 of the Treasury Review. Recommendation 5 equalises the treatment of the notional upstream and downstream entities between loss and profit situations.

Section 24 is amended so that the formula in subsection 24(b) applies in all circumstances. Prior to this amendment, the formula in subsection 24(b) only applied in profit situations (netback price greater than cost-plus price).

The amendment prevents a project's notional loss (netback price is less than the cost-plus price) being attributed solely to the upstream part of the project. The amendment provides a symmetric treatment between the netback and cost-plus price in both profit and loss situations.

<u>Part 5 (Sections 31 and 41A) - Capital Costs for Facilities Entering the PRRT System</u>

Part 5 of Schedule 1 to the 2024 Regulations implements recommendation 11 of the Treasury Review. Recommendation 11 includes appropriate costs in the upstream cost base, with an appropriate way of bringing upstream and downstream costs of capital equipment that were previously not included in the PRRT regime into the calculations of the RPM.

Step 1 of the RPM requires taxpayers to, under section 31, identify all types of cost associated with the integrated operation up to and including the assessment year. Section 31 sets out the types of costs associated with an integrated operation. Broadly, existing subsection 31(2) requires taxpayers to include all costs incurred by the participants that are attributable to the operation, whether incurred during the operating life of the operation or before the production year.

Broadly, the new provisions in section 31 operate in relation to 'brought-in units of property'. These are units of property which were not originally intended to be used in the relevant operation but are later used in the operation. The new provisions in section 31 are intended to remove all costs incurred in relation to these units of property from the scope of subsection 31(2), and for these costs to instead be exclusively dealt with under subsection 31(8). Subsection 31(8) only allows for some of these costs to be included, which are generally the original construction costs of the unit of property. To bring these original costs to current values, the original costs are indexed by the GDP deflator formula at subsection 41A(2).

The Regulations introduce new subsection 31(2A). This subsection ensures that costs incurred in relation to the acquisition of a brought-in unit of property (e.g., purchasing and leasing costs) are not included under subsection 31(2).

Subsection 31(7) provides the meaning of 'brought-in unit of property'. A unit of property is a brought-in unit of property if:

- when the unit of property was created, the unit of property was not used or intended to be used in any other relevant operation;
- the unit of property was later used in the relevant operation; and
- before the unit of property was first used in the relevant operation, the unit of property was not used in a petroleum project.

Subsection 31(8) states which capital costs incurred in relation to a brought-in unit of property are included. Costs are included to the extent all the following conditions are satisfied in relation to cost:

- The cost was incurred by a person who was an owner of the unit of property at the time the cost was incurred.
- The cost was incurred in respect of the construction, improvement or maintenance of the unit of property.
- The cost was not a payment or allowance between owners of the unit of property.
- The cost was incurred before the 31 December of the year of tax in which the unit of property was first used to carry out any of the actions mentioned in section 8 in relation to the relevant operation.
- The cost was not incurred for the purpose of preparing the unit of property to be used in the relevant operation.
- Either or both of subparagraphs 36(1)(b)(ii) and (iii) apply to the cost (broadly, ensuring the cost is of a capital nature).

A cost included under subsection 31(8) may be treated as a cost partly attributable to the operation if the brought-in unit of property has also been used in relation to another relevant operation. If it is partly attributable to the relevant operation, the amount of the cost is taken to be the amount that can reasonably be apportioned to the operation.

New section 41A indexes costs included under subsection 31(8). For the purposes of step 9 of the RPM, section 41A applies to costs included under subsection 31(8). The included capital cost is indexed by applying the following formula:

$$Included\ capital\ cost \times \frac{GDP\ deflator\ for\ the\ first\ processing\ year}{GDP\ deflator\ for\ the\ start\ year}$$

The term ‘GDP deflator’ in this formula uses the meaning of GDP deflator in section 2A of the Act. For a year of tax, this is worked out by dividing the GDP deflator for the year of tax by the GDP deflator for the immediately preceding financial year.

Broadly, the formula increases the value of included capital costs to their present-day value. The formula achieves this according to the period from the time when the cost was originally incurred to the time when the relevant property was first used in the relevant operation.

Where taxpayers do not have sufficient information about the original costs, this will generally mean that section 25 (RPM price where information is not available) will apply. Section 25 requires the Commissioner to determine an RPM price that is a ‘fair and reasonable price’ (subject to certain conditions). If section 25 applies merely because a taxpayer does not have sufficient information about the original costs, it may be possible for the Commissioner to apply section 25 in a way which merely involves deeming certain information about the original costs. However, this will depend on all the facts and circumstances, including whether the Commissioner is concerned about any artificiality or contrivance in the taxpayer’s dealings.

Part 4 (sections 42 and 42A) - Asset Life Formula Election

Part 4 of Schedule 1 to the 2024 Regulations implements recommendation 3 of the Treasury Review. Recommendation 3 requires projects to make an irrevocable election to use the shorter or longer asset life formula to remove the integrity risk that projects change the operating life of units of property to benefit from a higher capital allocation amount allowable under the shorter asset life formula.

For each included capital cost, step 10 of the RPM requires taxpayers to allocate to each year of tax from the production year onward a cost, with the amount of the cost given by section 42. Broadly, section 42 (as amended) sets out how capital costs are allocated to a year of tax, with this being done in reference to the ‘capital allocation period'.

'Capital allocation period’ means:

- for a unit of property in relation to which an election under section 42A is made, the meaning given by section 42A; or
- for any other unit of property, has the meaning given by subsection 42(6)

Despite section 42A and subsection 42(6), subsection 42A(7) provides a rule in relation to costs that are capital costs only because of subparagraph 36(1)(b)(i). These costs are taken to have been incurred in relation to a unit of property that has a capital allocation period that is the expected operating life of the operation.

New section 42A provides that the participants in a relevant operation may, for a unit of property used in the relevant operation, elect to use a particular number of calendar years as the capital allocation period for the unit of property for the purposes of section 42. Various rules apply in relation to an election, including the following:

- The election must be made by all participants in the operation jointly.
- The election must be made in writing.
- The election must specify the capital allocation period for the unit of property.
- The election may only be made before the first time a PRRT return is given to the Commissioner, in relation to the relevant project for the relevant operation, at or after the time the unit of property is first used in the relevant operation. Note, subsections 42A(5) and (6) provide transitional rules in relation to units of property in use at the time the 2024 Regulations commence.
- The election is irrevocable.
- If an election has been made and one or more new participants are later added to the relevant operation, then the election continues in force for the participants who made it, and any new participant is also taken to have made the election.
- If an election has been made under this section for a particular unit of property, the election continues to apply to the unit even if the unit ceases being used in the relevant operation or the unit is used in another relevant operation.

If the participants do not make an election under section 42A for a particular unit of property, the capital allocation period for the unit of property will be determined under subsection 42(6), which broadly provides that:

- the capital allocation period for the unit of property is the period of calendar years between the time the cost was incurred and the time the unit of property is expected to no longer be used in the operation; and
- the method in subsection 42(4) must be used to work out the annual allocation for capital costs incurred in relation to the unit of property.

Part 7 – Minor amendments

Part 7 of Schedule 1 to the 2024 Regulations makes minor amendments to the 2015 Regulation. These amendments are consistent with the policy intent of the 2015 Regulation and are not intended to substantively alter the operation of the 2015 Regulation.

Sections 6 sets out when an integrated Gas to Liquid (GTL) operation exists. Subsection 6(3) provides the meaning of ‘project sales gas’ in relation to an integrated GTL operation. PRRT may be payable in relation to project sales gas.

An integrated GTL operation exists if there is an operation (the ‘overall operation’) in which:

- petroleum is, or will be, recovered from a petroleum project; and
- sales gas is, or will be, produced from some or all of the petroleum; and
- some or all of the sales gas is, or will be, processed into a liquefied product.

Subsection 6(3) is amended to make clear the intended meaning of 'project sales gas'. The project sales gas of an integrated GTL operation is the sales gas (being the sales gas that is, or will be, produced from some or all of the petroleum) that:

- will be processed into liquefied product within the overall operation; or
- will, after becoming an excluded commodity, be used in the downstream stage of the operation in relation to the processing of sales gas (being the sales gas that is, or will be, produced from some or all of the petroleum) into liquefied product (note, under paragraph 24(1)(e) of the Act, not all sales gas that becomes an excluded commodity will be subject to the regulations).

Where sales gas (the 'destroyed sales gas') is destroyed in relation to the processing of other sales gas into liquefied product, then the destroyed sales gas is intended to be taken to be 'used' in relation to the processing of the other sales gas into liquefied product.

Broadly, the amendments ensure that, for the purposes of paragraph 19(6)(b) and subsection 20(6), sales gas that is used in relation to the downstream processing of sales gas into liquified product (for example, sales gas that is converted into electricity to operate downstream facilities) must be included in the volume or mass of project sales gas to which the RPM price is then applied to work out a taxpayer's assessable receipts.

Similar amendments are made in relation to section 7, which deals with integrated gas to energy operations.

Part 6 - Transitional provisions

Section 56 provides that the 2024 Regulations apply in relation to a year of tax beginning on or after 1 July 2024.

The 2024 Regulations also includes a general sunsetting transitional provision to ensure that actions, such as the making of applications or elections and the giving of notices and permissions, taken under the 2005 or 2015 Regulations continue to apply as if they had been taken under the 2024 Regulations.