EnergyResources Aotearoa
POWERING A BETTER NEW ZEALAND TOGETHER

energyresources.org.nz
energymix.co.nz
PO Box 25259, Wellington 6140

25 January 2022

Paul Fulton
Inland Revenue Department
via email paul.fulton@ird.govt.nz

Submission on the review of the seven-year spreading rule

Introduction

1. Energy Resources Aotearoa represents people and firms in the energy resources sector, from explorers and producers to distributors and users of natural resources like oil, LPG, natural gas and hydrogen.
2. This document constitutes our submission to Inland Revenue on its *Petroleum development expenditure: Review of the seven-year spreading rule*, which was initiated through a consultation letter.[i]

Overview and guiding principles

3. From first principles, our core public policy position is to support free markets (except where demonstrable market failure is present) and to oppose government subsidies for private enterprise. Tax policy should avoid distortionary effects in the economy which lead to an inefficient allocation of resources. In seeking to reform policy in line with those principles, transitional matters must be carefully considered, both in terms of honouring the legitimate expectations of existing businesses and not unduly compromising other public policy objectives.
4. As shown in a joint ministerial briefing note from 2018,[ii] the petroleum sector in New Zealand (rightly) receives no subsidies. The briefing note did however view the seven-year rule as concessionary compared to alternative settings, so there is merit in Inland Revenue reviewing it.
5. In undertaking the review and making policy recommendations, care is needed given investment decisions were made which factored in the seven-year rule, and such policy recommendations may have implications for the energy security of New Zealand. Repeal would represent a substantive change to tax policy and it would change field economics, so it should not be considered as merely a

remedial change. This also suggests that strong analysis and cost benefit is needed before any change is progressed.

Responses to Inland Revenue questions

Inland Revenue question one: "Should the seven-year spreading rule for petroleum development expenditure be retained or should it be repealed?"

6. We consider that the seven year period is not *inherently* a concessionary method, but merely reflects the fact that the useful life of a production well or other specific petroleum mining asset cannot be estimated with precision, and may generally be expected to be less than the estimated useful life of the producing reservoir.

7. In principle, if the seven-year spreading rule is shown to have concessionary elements, repealing it may be sound public policy, but that assessment depends on the counterfactual method that it is compared to as well as weighing up further adverse flow-on effects on investment in the sector.

Need to consider negative benefits from repealing the seven year rule and the benefits of policy stability

8. Even if the seven-year method is considered concessionary, adjusting it may come with certain negative costs. Such downsides would, most fundamentally, be the impact on investment confidence and consequential impacts on energy security. The gas market is tight and will remain so into the medium term and even the long term unless the upstream petroleum sector (i.e. natural gas producers) invests capital, and further policy changes may inhibit that thereby putting New Zealand at a net disadvantage.

9. Given the significant punitive regulatory reform imposed on the sector since 2018, we see merit in minimising regulatory change and further sovereign risk at a time of significant regulatory uncertainty for the sector. The investment climate for new natural gas developments has rapidly changed and is being greatly influenced by government policy settings. The co-regulatory Gas Industry Company, in its recent Gas Market Settings Investigation found that:

> "Despite the outlook showing there are sufficient reserves in the ground to meet New Zealand's gas demand, without ongoing investment well in advance of when the gas is needed, there is a real risk that not enough gas will be able to be delivered to major gas users, including electricity generators, during the transition out to 2030 and beyond."[iii]

10. Further, the implications of repeal of the seven year rule need to be considered against the Governments overall intended policy outcomes. Repeal of the seven year rule may incentivise *oil* exploration and production over *natural gas* exploration and production. This is because gas production is constrained by the demand side which means gas production occurs over longer periods of time than oil production.[iv] This longer production timeframe is more negatively

affected by the time value of money associated with using the reserves depletion method as compared to the seven year rule.

11. The sector currently faces a cacophony of negative signals which add significant risk (especially for the next cycle of investments which may see production beyond 2030) for those considering investing in natural gas projects. The upstream petroleum sector operates with significant technical and commercial risks as it is, so adding political and policy risk compromises a key factor that has traditionally made New Zealand's sector attractive to invest in.

Quantification of the cost would be informative and useful

12. The seven-year rule may have a concessionary aspect given the time-value of money compared to the alternative of spreading over longer periods of time if the reserve depletion method is used (assuming field life is longer than seven years). Some monetary quantification of the cost to the Crown would help to determine the extent of any concession and inform whether reform is worthwhile when balanced against negative benefits from a policy change.

The importance of transitional/grandfathering policies

13. If the seven-year period is to be repealed, an important transitional question arises in relation to petroleum activity that was commenced before this policy change was proposed. As this submission will explain, this point means that from the standpoint of good public policy a split approach between existing and wholly new activity should be adopted.

Inland Revenue question two: "If the seven-year spreading rule is repealed, should the reserve depletion method become mandatory for all production fields but not for already-incurred expenditure?"

14. Should the seven-year rule be replaced, the question of 'what with?' is of utmost importance. The consultation letter from Inland Revenue is quite clear that the only alternative being considered is the already-existing reserves depletion method, which means officials should satisfy themselves that it serves as a fair and suitable policy if it is become the only option. We, however, are not sure this is the case.[v]

15. As we cover in response to the next question on transitional matters, it is important to provide for grandfathering of all existing exploration and production operations who commenced business on the expectation that rules are stable and predictable.

Inland Revenue question three: "What other transitional settings would be appropriate? Are there any other transitional issues you can see arising from the proposal?"

16. If the Government decides to repeal the seven-year rule, it is important to consider and account for the distinction between new activities and activities established under the current legislative framework.
17. We could accept the Government repealing the seven year rule for new activities, but only if existing exploration and mining fields/permits/licences are exempt from the amendment via grandfathering provisions. Such grandfathering would respect the legitimate expectation that permit holders could rely on stable policy settings going forward, and would maintain the expectation that tax settings are durable and not applied retrospectively to existing activities.
18. Any transition to the reserves depletion formula would require amendment of the Income Tax Act definition of denominator, "probable reserves", and in the process, potential alignment with generally accepted accounting practice for determining the formula denominator. The accounting denominator is generally "developed proven reserves" with reliance generally placed on US GAAP ASC 932 for reserve measurement, however, other variations are also applied in practice. It appears that amendments may also be required to accommodate practical scenarios, for example, how any reserves or petroleum mining assets purchased during a year are allowed for in the current formula which is based on opening balances of reserves. Such amendments appear to be both a pre-requisite to mandatory use of the reserves depletion method and require extensive consultation with industry, in order to ensure outcomes that are appropriate, able to be applied by all industry members and verifiable for both industry and Inland Revenue.
19. Altering the seven year rule for planned activities can alter field economics and compromise decisions to invest in new petroleum resources which are important for energy security (as well as regional development and Crown royalties).
20. We have specifically mentioned exploration permits as being suitable candidates for grandfathering, even though production is not immediately in sight. This is because explorers enter New Zealand following careful due diligence on tax settings and will have factored in the seven year rule into potential development and production operations. Grandfathering exploration permits honours this expectation and would avoid compromising New Zealand's traditional reputation as a stable regime.

Conclusion

21. If the seven year rule is deemed to be concessionary and therefore undesirable, its repeal can be justified providing:
    - implications for investment and energy security have been considered
    - benefits exceed costs; and
    - the alternate depreciation regime is demonstrated to be suitable.

22. To inform this analysis, a financial quantification of any losses to the Crown from the current policy should be undertaken.

23. Should the rule be repealed, this should only be for new exploration and production permits, so as to ensure stable settings for incumbents who made decisions to enter New Zealand and invest on the basis of policies which they legitimately expect to remain in place.

24. Should officials decide to progress repeal of the seven-year rule, we ask that the sector be kept involved in policy discussions. We would appreciate the opportunity to further discuss the reserve depletion method so that Inland Revenue can better understand our hesitations about that being the default under the current policy trajectory.

---

[i] Letter entitled *Petroleum development expenditure: Review of the seven-year spreading rule*. Dated 18 November 2021 and sent by Policy Director Emma Grigg.

[ii] Aide Memoire, Meeting with the Minister for Climate Change on fossil fuel subsidy reform. Prepared by MBIE, tracking number 1674 17-18. Dated 30 January 2018.

[iii] Gas Industry Company. Gas Market Settings Investigation. 30 September 2021.

https://www.gasindustry.co.nz/work-programmes/gas-market-settings-investigation/developing-2/final/document/7342

[iv] Gas production is constrained by domestic demand (as there is no current export market), but oil production is not (as it is nearly all exported),

[v] The Income Tax Act section EJ12b definition of "probable reserves" incorrectly includes only probable reserves in the denominator. Producing proved undeveloped reserves or probable reserves requires future capex which may or may not eventuate. Using proved developed reserves as the denominator in the amortisation calculation matches the historical capex with production of the reserves that capex has developed. When further capex is expended it is expected that more reserves will shift into the proved developed category, so the quantum of capex being amortised and reserves it is being spread over both increase. This is the way accounting works. The current reserve depletion method for tax purposes is spreading prior capex incurred over reserves that may never be developed, proven or produced, and if they are developed and produced will require new capex to achieve that. It is the new capex that belongs with the new proved developed reserves and should be amortised with those new proved developed reserves.

Consider the following oil field example:

- 60bbls of proved developed reserves
- 40bbls of probable reserves
- Capex to date of $100
- 10 year production life for the proved developed reserves
- Estimated capex of $200 to prove and develop the probable reserves

Amortisation under the reserve depletion method would result in $60 of deductions over 10 years. If the probable reserves are never developed the company is left with $40 of undeducted PDE at the end of field life. If the probable reserves are developed when the original proved developed reserves are fully produced, the company will have to amortise the remaining $40, that was spent to develop the original proved reserves, over the production life of the new proved reserves. This seems completely inappropriate. The equitable method is to spread capex deductions over the life of the proved developed asset the company has after expending that capex, not to spread it over the life of some future asset that can only come into existence with new capex that may or may not ever eventuate.