Ruling Compendium of Views – TR 2013/D4

Consultation with industry occurred prior to the issue of this ruling as a draft. Various views and issues were raised as part of that consultation process. The following are the ATO's record of the views and issues raised in consultation, as well as other views known to exist, and the ATO responses to those views and issues.

Summary of views and issues raised and responses

Issue 1: There is a trade, technical or special meaning of 'exploration' or 'exploration for petroleum' which, rather than the ordinary meaning, applies in the Act.

ATO response to Issue 1

1. The ordinary meaning of the word applies in its statutory context unless some technical or special meaning is indicated, per French J:

> It is necessary as always to begin the task of construction by reference to the words of the Act applying their relevant ordinary meaning ascertained by reference to context and legislative purpose unless some technical or special meaning is indicated.[1]

2. For a word to be construed by reference to its trade meaning there has to be evidence of the fact that the word both has a trade meaning and one that was uniformly accepted by the petroleum and gas industry (*Re Pacific Film Laboratories Pty Ltd and Collector of Customs* [1979] 2 ALD 144; *Collector of Customs v. Agfa Gevaert Ltd* (1996) 186 CLR 389; *Anderson v. Wadey* (1899) 20 NSWR 412 at 417).

3. The existence of any such usage has to be strictly proved. As Knox CJ said in *Thornley v. Tilley* [1925] HCA 13; (1925) 36 CLR 1:

> The extent to which evidence of the existence of a custom or usage must go is defined by Jessel MR in *Nelson v. Dahl*[2] He says: – 'That' [i.e., the existence of the alleged usage] 'is a question of fact, and, like all other customs, it must be strictly proved. It must be so notorious that everybody in the trade enters into a contract with that usage as an implied term. It must be uniform as well as reasonable, and it must have quite as much certainty as the written contract itself.'

4. Further, the evidence would need to address the existence of a common commercial or trade usage as at the date of the passing into law of the Act (*Herbert Adams Pty Ltd v. Federal Commissioner of Taxation* [1932] HCA 27; (1932) 47 CLR 222).

5. Section 15AB of the *Acts Interpretation Act 1901* (Cth) makes it clear that there will be cases where evidence of industry practice or standards may be used as an aid in the interpretation of Commonwealth legislation. However, a court will determine if a word is used in a technical or special sense, and will take evidence on what a word's technical meaning is.

6. It is not enough to show that a word has a technical or trade meaning. It must also be shown that the word has been used with that technical or trade meaning in the legislation.

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[1] *Woodside Energy Ltd v. Federal Commissioner of Taxation (No2)* (2007) 69 ATR 465; [2007] FCA 1961 at paragraph 261

[2] *Nelson v Dahl* (1879) 12 Ch D 568 at p. 575.

7. In the Commissioner's view, the words 'exploration' or 'exploration for petroleum' are used in the *Petroleum Resource Rent Tax Assessment Act 1987* (the Act), including section 37 and section 38 in their ordinary sense, and not in any technical sense. Further, the Commissioner does not accept that it has been shown there is a particular trade or technical meaning of 'exploration' or 'exploration for petroleum' across the industry as would differ from the ordinary meaning of those words. References may be identified where the words are used in their usual ordinary sense (to cover exploration or appraisal wells) and while some other references may refer to exploration in search of 'commercial' finds or discoveries, no consistency has been demonstrated in the use of the term across industry, and it cannot be concluded that the concept of exploring for a 'commercial' find (which is what every petroleum miner is seeking to do) actually embraces activities which are connected to determining whether commerciality exists.

8. It has also been suggested that a trade meaning may attach to the term 'exploration phase' and that this can be distinguished from the 'production phase' (or from the 'development phase' and the 'production phase').

9. It has been suggested that the 'exploration phase' commences with the grant of an exploration permit and if petroleum is discovered, then it continues until a decision is made to proceed with production (this decision is generally referred to as the Final Investment Decisions (FID)) or to abandon the project.

10. In *Petroleum rent collection around the world* by Alexander Kemp of The Institute for Research on Public Policy it is stated:

> When contemplating an exploration program, investors have to consider all the factors discussed above in addition to the most basic risk, namely, that of finding petroleum in commercial quantities. At the **exploration phase** [emphasis added] the investor has to consider not only the chance of finding oil but also the likely sizes of the fields, their exploitation costs, and the revenues which could be obtained.[3]

11. In the Australian Bureau of Agricultural and Resource Economics (ABARE) Research Report No 96.4 (ABARE Report) it is stated on pages 23 to 24:

> **Key stages in the exploration, development and production of oil and gas resources**
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> Although there is considerable uncertainty in the BRS assessment, Australia is likely to have significant quantities of undiscovered oil and gas resources. Exploration is required to discover the location, size and quality of oil and gas fields. Producers must identify the appropriate technology, subject to environmental and other constraints, for the development of the field. If a field is assessed to be economic – in the case of gas or LNG, long term contracts must be established for sales – the field is subsequently developed and economically recoverable share of the oil and gas resources is produced. Notably, there are significant time lags involved in the exploration, development and production of oil and gas …
>
> In the **exploration phase**, oil and gas companies use a range of survey techniques to identify prospective fields. These may be geological, gravity, magnetic, seismic (2D and 3D) or geometrical surveys. In prospective areas, new field wildcat wells are drilled to discover the location of accumulations. In the event of a discovery, appraisal wells may also be drilled to provide a more accurate indication of the potential size and quality of the oil and gas resources. If the discovery is significant, a feasibility study of the field for future development and production is undertaken.

[3] Kemp, AG, 1987, *Petroleum rent collection around the world,* The Institute for Research on Public Policy, Canada, p. 12.

> The **development phase** involves the construction of the infrastructure required for the production of the resource. Depending on the location and resource type, this infrastructure includes development wells, production facilities, a gathering system to connect individual wells to processing facilities, temporary storage facilities, and transport facilities such as pipelines, ships or trucks. Offshore and onshore accommodation facilities may also be required. There is an important distinction in the production process required for oil and natural gas. Oil field developments can incorporate relatively simple storage and mobile transport facilities. However, this is not the case for gaseous products. Gas producing wells must be connected to pipeline facilities. Nevertheless, **irrespective of the fuel type, the oil and gas extraction process involves a complex set of integrated processes**. [emphasis added][4]

12. It has been further asserted that the point where reserves are 'booked' gives a clear indication that a commercially recoverable petroleum source has been located and evaluated and that development is justified. The position has been advanced that the point where reserves are 'booked' could be seen (on an industry-wide consistent basis) as the point where the 'exploration phase' has ended and the 'development phase' begins.

13. It has also been asserted that industry-wide consistency as to the point where reserves are 'booked' is provided through the use of the Society of Petroleum Engineers-Petroleum Resources Management System (SPE-PRMS).

14. The Commissioner accepts that the use of the SPE-PRMS can provide a consistent reporting mechanism of the establishment of commercial viability of a potential project, and may well give a clear indication of the end of an 'exploration phase' and the beginning of a 'development phase'. However, the Commissioner does not accept that expenditure incurred prior to the booking of reserves will automatically be considered to be exploration expenditure, nor that expenditure which is incurred after the booking of reserves cannot be exploration expenditure. The critical consideration in determining whether the expenditure is exploration expenditure is the nature and purpose of the expenditure.

15. Consistent with the position stated in the draft ruling, in the Commissioner's opinion, even if there is a 'trade usage' of the term 'exploration phase', such a trade usage would not be relevant in interpreting section 37 of the Act. 'Exploration phase' is not a term used in the Act. The distinction between exploration and other phases is not a relevant distinction for the purposes of the Act. The relevant distinction referred to in the Act is those relating to exploration expenditure, general project expenditure and excluded expenditure. This contention is consistent with the Tribunal's summary of the Commissioner's submission at paragraph 301 of *ZZGN v. Commissioner of Taxation* [2013] AATA 351 *(ZZGN)* and with the Tribunal's comments in paragraph 314 of *ZZGN*.

16. In summary, in the Commissioner's opinion, there is no indication in the Act (or in relevant extrinsic materials) that the term 'exploration' or 'exploration for petroleum' carries a meaning other than its ordinary meaning. Nor does the Act provide any basis for preferring a trade usage of 'exploration' or 'exploration for petroleum' above the ordinary meaning of the term. The Commissioner's view is consistent with those of the Tribunal in *ZZGN*.[5]

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[4] Hogan, L., Thorpe, S., Zheng, S., Ho Trieu, L., Fok, G. and Donaldson, K. 1996, *Net Economic Benefits from Australia's Oil and Gas Resources: Exploration, Development and Production,* ABARE Research Report 96.4, Canberra, pp. 23 – 24.

[5] See paragraphs 312 to 314 of *ZZGN*.

Issue 2: Decided cases do not support the Commissioner's interpretation of the ordinary meaning of exploration.

17. It has been suggested that the ordinary meaning of exploration in the draft ruling is too narrow as there is *dicta* in case law in other contexts which supports the view that 'exploration' has a wider meaning than searching for petroleum and the physical appraisal thereof.

18. Cases that have been cited to support this proposition are *Esso Australia Resources Ltd v. Federal Commissioner of Taxation* (1997) 144 ALR 458 (*Esso*), *Esso Australia Resources Ltd v. Commissioner of Taxation* (1998) 84 FCR 541, *Mount Isa Mines Ltd v. Federal Commissioner of Taxation* (1954) 92 CLR 483 (*Mount Isa Mines*) and *Mitsui & Co (Australia) Ltd v. Commissioner of Taxation* (Cth) [2012] FCAFC 109 (*Mitsui*).

ATO response to issue 2:

19. The *ZZGN* decision is the first decision to consider the exploration concepts in paragraph 37(1)(a) of the Act. The views of the Tribunal in *ZZGN* have been incorporated into the ruling and explanation sections of the draft taxation ruling (where relevant).

20. The Commissioner considers that the cases referred to were all decided in considering different statutory provisions and statutes, with their own legislative history, purpose and context. In none of the cases cited did the courts specifically have to consider the meaning of 'exploration' or 'exploration for petroleum' in the context of, or with reference to the statutory framework and legislative history surrounding paragraph 37(1)(a) of the Act.

21. For example, in *Esso*, Sundberg J (at first instance) considered certain evaluation activities of the taxpayer, albeit in the context of whether the expenditure was deductible under subsection 51(1) of the *Income Tax Assessment Act 1936 (*ITAA 1936) and not the Act.

22. His Honour stated at [467]:

> In each year of income the taxpayer claimed as a deduction the expenditure it had incurred in investigating the acquisition of interests in potential joint ventures for the exploration and mining of coal, oil shale and minerals.
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> …
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> The nature of the evaluation varied from case to case. Sometimes there was a simple in-house review of published geological information. In other cases there was a full-scale study requiring on-site work, geological review, mine planning, marketing studies and a full economic appraisal.

23. His Honour concluded that the taxpayer was not entitled to an income tax deduction for the cost of those activities because they were exploration costs and the taxpayer's business was not an exploration business. In reaching that conclusion, his Honour stated at [470]:

> The costs in question were of course incurred in the course of the taxpayer's exploration activities. But in the relevant years the taxpayer was not in the business of exploration. It did not engage in exploration for reward. It did not sell any of its exploration information, or otherwise earn fees for its exploration activities.

24. The Full Federal Court on appeal, in *Esso Australia Resources Ltd v. Commissioner of Taxation* (1998) 84 FCR 541 (Lee, Heerey and Merkel JJ) held [at 556] '*no error has been demonstrated in relation to his Honour's characterisation of the appellant's exploration activities…'*.

25. The decision by Sundberg J in *Esso* was not about the meaning of exploration, but rather about the meaning of 'petroleum' as defined in the ITAA 1936. It is noted that Sundberg J also made a number of observations as to the nature of activities that may be considered to be exploration, but in the context of whether the taxpayer was conducting a 'business of exploration'. His Honour did not make a finding as to what constitutes the ordinary meaning of 'exploration' as it was not required to determine the issue under consideration by the court.

26. In *Mount Isa Mines*, the decision of Taylor J did not concern the meaning of 'exploration' but rather addressed the issue whether expenditure on housing and amenities was expenditure incurred on the development of a mining project for the purposes of former section 122 of the ITAA 1936. In the Commissioner's view Taylor J's observations in *Mount Isa Mines* regarding what may occur during the 'exploration phase' and what may occur during the 'development phase' of a mine were directed at a different section of a different statute. They do not support the proposition that all work undertaken before the decision to mine is made (such as the best way to mine) is 'exploration' as opposed to developmental in nature.

27. The *Mitsui* case was concerned with the operation of section 40-30 of the *Income Tax Assessment Act 1997* (ITAA 1997), which provides what a depreciating asset is. The question being considered by the court was whether part of the consideration paid to acquire an interest in a production licence granted under the *Petroleum (Submerged Lands) Act 1967* was allowable as a deduction in the year of payment. Broadly, the court was asked to consider whether the 'right to explore' and the 'right to produce' that are available when a production licence is acquired, or the fact that the production licence covered two discrete accumulations of petroleum gives rise to two separate depreciating assets. The court was not asked to consider the ordinary meaning of exploration.

28. The Commissioner does not accept that the cases referred to establish a meaning for the term 'involved in or in connection with exploration for petroleum' in the context of section 37 of the Act that is wider than the ordinary meaning of the terms put forward in the draft ruling. These cases were considered by the courts in the context of, and with reference to, the statutory framework and legislative history of the specific provisions being considered. Any discussion of 'exploration' set out in those cases must be considered in that light. In the draft ruling, in framing his view, the Commissioner has considered the ordinary meaning of the term 'exploration' or 'exploration for petroleum' in the context in which it appears in section 37 of the Act.

29. For the reasons stated, the Commissioner does not believe that the cases referred to extend the ordinary meaning of those terms in the context of section 37 of the Act.

30. It is also noted that the Tribunal in *ZZGN* were of the view that the *Esso* and *Mount Isa Mines* cases are not relevant to the meaning of exploration in subsection 37(1) of the Act.[6]

[6] See paragraphs 315 and 316 of *ZZGN*.

Issue 3: The phrase 'involved in or in connection with' broadens the meaning of exploration expenditure to include economic feasibility studies.

31. It has been asserted that expenditure incurred in carrying on or providing operations or facilities that have a broad relationship with exploration are contemplated by section 37 of the Act. The argument is that paragraph 37(1)(a) of the Act provides for this broad relationship by including 'in carrying on or providing the operations and facilities *involved in or in connection with exploration for petroleum* in the eligible exploration or recovery area in relation to the project…' [emphasis added] within exploration expenditure. This broad relation would (on this argument) bring within section 37 expenditure incurred in evaluating the discovery from the point of view of technical and economic feasibility of the recovery from the petroleum pool (assuming that such expenditure did not fall within the ordinary meaning of exploration).

ATO Response to issue 3

32. The Commissioner does not accept that the wording of paragraph 37(1)(a) of the Act allows for the inclusion of expenditure incurred on operations or facilities that have a broad relationship with exploration to be included with exploration expenditure, unless the operations and facilities have a reasonably direct relationship to the exploration activities (as found in *ZZGN* at paragraph 390).

33. The Commissioner considers that the words 'involved in or in connection with' (exploration for petroleum) include all operations and facilities which exhibit, a direct or reasonably direct relationship, to the activity of searching for, and identifying, petroleum pools. A reasonably direct relationship may exist where operations and facilities assist, benefit, advance and/or advantage the task or activity of exploration.

34. The phrase does not, in the Commissioner's view, include activities that build on or utilise the results of exploration that has been carried out in order to determine the technical or economic feasibility of a potential project.

35. In each case, the nature of the relationship and the degree of connection required must be determined by the statutory context.[7] In considering expenditure on feasibility studies, the statutory context must include the operation of both paragraph 37(1)(a) and paragraph 38(1)(a) of the Act.

36. Evaluation of a petroleum pool that has already been discovered in order to determine if it is technically feasible or economically feasible to recover the petroleum will not have a reasonably direct relationship with the exploration for petroleum. However, such evaluation may build on what has already been identified through the process of exploration. In these circumstances, the feasibility studies will often be 'preparatory to' the carrying on or providing of the operations, facilities and other things which comprise the project (paragraph 38(1)(a) of the Act).

37. A further argument has been put that the words 'involved in or in connection with exploration for petroleum' expands the ordinary meaning of exploration. The Commissioner does not agree that the phrase expands the ordinary meaning of the word exploration. As noted above, the wording ensures that expenditure incurred in carrying on or providing all operations and facilities which exhibit a direct or reasonably direct relationship to the activity of searching for, and identifying, petroleum pools are included within exploration expenditure. The words do not modify or expand the ordinary meaning of exploration to include activities which are of themselves not related to searching for, or identifying, petroleum pools.

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[7] See *Woodside Energy Ltd v. Federal Commissioner of Taxation (No 1)* (2006) 155 FCR 357; [2006] FCA 1303 at paragraph 57.

Issue 4: The Commissioner's interpretation will lead to the potential for 'black-hole' expenditure.

38. Views have been expressed that the Commissioner's interpretation of the ordinary meaning of exploration together with his view of 'involved in or in connection with' exploration for petroleum will lead to expenditure (particularly in relation to economic feasibility studies) being 'black-holed'. That is to say, certain expenditure may not be recognised at all for PRRT purposes, or that expenditure may be recognised, but may never be able to be utilised.

39. These concerns have been raised in the context of the following scenarios:

- a project proceeds on the same basis as that considered in the economic feasibility studies
- a project proceeds on a different basis to that considered in any of the economic feasibility studies
- a project does not proceed

40. In the first two situations it is said that if the expenditure on economic feasibility studies and related activities is not expenditure 'involved in or in connection with exploration for petroleum' for the purposes of section 37 of the Act (on the view in the draft ruling), the expenditure may also not be general project expenditure for the purposes of section 38 of the Act. This is because, it is said, it is not preparatory to the particular project undertaken. It is further said that the expenditure will not be recognised in the Act and will not be able to be utilised.

41. In the third situation, even if the expenditure on economic feasibility and related activities would be general project expenditure for the purposes of section 38 of the Act, if there was a project, the fact that there is not a project means that the expenditure will be unable to be utilised.

42. These outcomes, it is argued, are not intended under the Act. In particular, it is suggested that 'black-hole' expenditure is not contemplated under the Act.

ATO response to Issue 4

43. The Commissioner does not support the contention that 'black-hole' expenditure is not contemplated under the Act.

44. As noted in the Budget Speech No. 1 (1990-1991):

> The existing single threshold was set to allow companies to carry forward each year the real value of exploration and development costs. The rate included a premium which recognised the possibility that companies ***would not be able to deduct costs of unsuccessful projects***. [emphasis added][8]

45. In the Second Reading Speech[9] to the *Petroleum Resource Rent Legislation Amendment Bill 1991* (Cth) (on 9 May 1991) the then Treasurer, the Hon Paul Keating, stated the following in relation to the policy underlying the proposed changes:

> The Bill also introduces a generous concession to exploration activities, permitting the deduction of exploration expenditure incurred from 1 July 1990 in respect of all offshore operations subject to the RRT, against RRT liability on a wider basis than at present.

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[8] See page 4.6 of Australia Treasury, 1990, *Budget speech and papers Nos. 1-4 1990-91*, Australian Government Publishing Service, Canberra.

[9] House of Representatives, *Debates* (1991) Vol HR177, pp 3436-3437

> …
>
> In recognition of the significant benefits to industry of wider deductibility of exploration expenditure, the existing carry forward arrangements for undeducted expenditures under the RRT will be modified.
>
> The new arrangement will ***reflect the relative likelihood of recovering exploration and development expenditures***, in contrast to the existing composite carryforward rate.
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> The carryforward rate for general expenditures incurred from 1 July 1990 will be reduced from the long term bond rate plus 15 percentage points to the long term bond rate plus 5 percentage points.
>
> Undeducted exploration expenditure will continue to be eligible for compounding at the long term bond rate plus 15 percentage points.
>
> …
>
> ***To minimise the risk that project-specific expenditure for unsuccessful or marginal projects would not be deducted***, the amendments will provide for an order of deductions that will ensure project-specific expenditures are written off first. [emphasis added]

46. When taking into account the overall design of the Act, the conclusion can be drawn that it was clearly within the contemplation of the Act that there will be situations where expenditure incurred in relation to a project or potential project may not be able to be utilised by a person. That is not to say that the expenditure is not potentially recognisable under either section 37 or section 38 of the Act, but rather the expenditure may not ultimately be able to be utilised by the person.

47. In the third situation, the contention is that if no project proceeds, expenditure on economic feasibility studies would not be expenditure 'in carrying on or providing' or 'preparatory to' as there is no project. The Commissioner considers that this is not necessarily an unintended outcome.

48. As a project-based tax, expenditure that would be general project expenditure where there is a project would not be available to be utilised (by a person) where a project does not commence. It is noted that such expenditure may be available if the project does commence at a later time (even if it goes ahead in a different form than which may have been previously contemplated).

49. For example, prior to acquiring a production licence a person could potentially undertake work in expectation of a production licence being obtained and a 'project' commencing. It may be that a production licence is, at the end of the day, not obtained. That being the case, that preparatory 'general project expenditure' would have no project against which it can be applied. The Commissioner considers that this is not an unintended or anomalous outcome in the context of a project-based tax and the design of the Act.

50. In the first two situations, where a project proceeds, whether or not on the same basis as that considered in the economic feasibility studies, the Commissioner considers that many such studies and related activities may be covered by paragraph 38(1)(a) of the Act. This is on the basis that such activities are 'preparatory' to the relevant activities referred to in that paragraph.

51. It seems to the Commissioner that the concept of 'preparatory' is likely to be a fairly wide one. That is, it would be expected to cover many economic feasibility studies relating to decisions to produce, FID and similar.

52. Support for this position can be drawn from the joint judgment of Keane CJ and Edmonds J in *Esso Australia Resources Pty Ltd v. Commissioner of Taxation* [2012] FCAFC 5 where, at paragraph 114, the following statement appears:

> It is also to be noted that s 38(a) of the Act expressly includes within general project expenditure payments liable to be made by the person 'in carrying on or providing operations and facilities preparatory to the activities referred to in subpara (b), including in carrying out any feasibility or environmental study'. **These preparatory activities are expressly included in general project expenditure on the evident basis that they would be too remote from the 'carrying on or providing the operations, facilities and other things comprising the project' to be comprehended by subparagraph (b) of s 38.** And yet these preparatory activities are more closely and specifically connected to the project than the work of the URC. [emphasis added]

53. It could be argued, based on the observation of the court that express inclusion of 'any feasibility study' was intended to capture feasibility studies which, whilst not directly leading to the way the operations or facilities comprising the project are implemented, were part of the process that led to that final outcome. For example, in considering and discarding a number of concepts the final concept was identified and progressed.

54. Had Parliament intended that only the feasibility studies that directly led to the way that the project was actually undertaken could fall within paragraph 38(1)(a) of the Act, it is unlikely it would have chosen to use the phrase 'any feasibility study' to identify feasibility studies that fall within paragraph 38(1)(a) of the Act and those that do not.

55. The Commissioner considers, however, that there must be a relevant connection between the feasibility studies conducted and the project that commences. For example, paragraph 38(1)(a) of the Act would not cover feasibility studies conducted in relation to another exploration permit area entirely. However, the fact that the project, when commenced, is carried on in a particular way in a specific production licence area does not preclude economic feasibility studies relating to other ways in which the project could have been undertaken from being expenditure within paragraph 38(1)(a) of the Act.

56. Where a project does commence, and that project was not the project considered in (any of the) economic feasibility studies, the expenditure on those economic feasibility studies, it is also said, would not be preparatory to the project that commenced. That is to say, on this view, the expenditure does not relate to, and was not preparatory to, the operations, facilities and other things set out in subsection 19(4) of the Act as comprising the project.

57. The Commissioner does not agree that this will always be the outcome. The same reasoning as appears in the above paragraphs would seem to be relevant here.

58. The Commissioner's view is also consistent with the Senate Explanatory Memorandum to the Petroleum Resource Rent Tax Assessment Bill 1987, in the notes to clause 38, where it is stated that:

> This clause describes amounts of expenditure which constitute general project expenditure incurred by a person in relation to a petroleum project. ***That expenditure, unlike exploration expenditure, is project-specific although it can include general project expenditure incurred prior to granting of a production licence (for example, expenditure on a feasibility study prior to the grant of that licence)***. [emphasis added].

59. From that statement, it seems that some general project expenditure, including feasibility study expenditure, is 'project-specific' in a slightly different sense. That is, in that it may be incurred prior to a production licence being issued (and hence a project existing), but will be relevantly connected with a project if, and when, a production licence is issued.

Issue 5: Exploration is undefined and involves, on the most reasonable commercial approach, both appraisal and evaluation of the resource because this is what petroleum miners do in practice before they decide to move to development and production.

60. The position has been put forward that there is no agreed definition of 'exploration'. Consequently, to understand what is meant by the words 'exploration' and 'exploration for petroleum' it is necessary to consider, from a practical commercial point of view, what occurs prior to a decision to produce. Where this approach is taken, it is argued, it would be apparent that the process of establishing that the resource once found is commercially recoverable (for example, economic feasibility studies and appraisal activities) would fall within 'exploration'.

ATO response to issue 5

61. The Commissioner does not dispute that once a petroleum pool is discovered, many studies and evaluations may be undertaken and expenses incurred before a conclusion is reached that the recovery of petroleum is commercially viable and a decision to produce can be and is made.

62. However, the Commissioner does not agree that all such studies and evaluations will fall within paragraph 37(1)(a) of the Act, notwithstanding that the expenses may be incurred in what might be described in the industry as 'an exploration phase'. A distinction must be drawn between ascertaining the extent of the discovery and appraising its physical characteristics (which would be within the ordinary meaning of exploration), with evaluating the economic feasibility of recovery and ascertaining the best method to use in recovery (which would not fall within the ordinary meaning of exploration or be involved in or in connection with exploration for petroleum).

63. The Commissioner considers that the ordinary meaning of exploration is limited to the discovery and identification of the existence, extent and nature of petroleum pools. This includes searching in order to discover the resource, as well as the process of ascertaining its size and appraising its physical characteristics. Establishing the commercial viability of a discovery is, in the Commissioner's view beyond the ordinary meaning of exploration and not involved in or in connection with exploration for petroleum.

64. Therefore, it does not follow that all expenditure incurred during what is or can be described as an exploration phase must be exploration expenditure. Put another way, the Commissioner does not agree that all expenditure incurred before the development stage (that is before the FID is made) must be exploration expenditure. Nor does the Commissioner accept that general project expenditure can not be incurred prior to the FID being made. The Commissioner considers that the character of expenditure is determined by its nature and purpose and not whether it is incurred during a particular phase.

65. Views expressed by the Tribunal in *ZZGN* are consistent with the above.[10]

[10] See paragraphs 314, 319, 321-322, 387 and 389 of ZZGN

Issue 6: The specific inclusion of expenditure on obtaining retention leases would indicate that expenditure on economic feasibility studies should be included as exploration expenditure.

66. It has been asserted that, because fees associated with obtaining a retention lease are specifically included in exploration expenditure under section 37 of the Act, costs incurred to be in a position to obtain a retention lease should likewise be included within exploration expenditure.

67. It is argued that, in order to obtain a retention lease you must be able to demonstrate that a non-commercial discovery will become commercially viable within a certain timeframe. In order to be able to do that, you would need to conduct technical and/or economic feasibility studies.

68. It therefore follows (according to the position advanced) that the expenditure incurred in conducting the technical and or economic feasibility studies needed in order to be in a position to obtain a retention lease should also fall within exploration expenditure. The argument is that because a condition for the granting of a retention lease is that it is shown that the project is not currently commercially viable, it would seem illogical that the provision includes a fee to obtain the lease, but does not include the operations that lead to the assessment of commercial viability (needed in order to obtain the lease).

ATO response to issue 6

69. The Commissioner does not accept that the specific inclusion of certain retention lease fees as exploration expenditure within subsection 37(1) of the Act means (of itself) that expenditure incurred in conducting the technical and or economic feasibility studies (needed in order to obtain the retention lease) should also fall within exploration expenditure. To determine if expenditure on such technical and or economic feasibility studies falls within exploration expenditure, the same conditions must be satisfied as for any other expenditure.

70. The Commissioner considers that such studies do not fall within the ordinary meaning of exploration, as they are not directed to the discovery of the resource, or to the process of ascertaining its size and appraising its physical characteristics, nor are they 'involved in or in connection with exploration for petroleum' as they do not have a reasonably direct relationship with the exploration.

71. It is not disputed that the outcome of the feasibility studies will inform the decision making process involved in seeking a retention lease, and will be essential in demonstrating that a non-commercial discovery may be commercially viable within the required timeframe. The studies will not, however, have the required connection with the activity of exploration.

Issue 7: The definition of exploration and prospecting in subsection 40-730(4) of the ITAA 1997, or the way the Commissioner has administered this law and predecessors to it (see Taxation Ruling IT 2642[11](withdrawn) and Taxation Ruling TR 98/23[12]) informs the proper interpretation of exploration for petroleum in section 37 of the Act.

72. It has been suggested that the specific inclusion of economic feasibility studies after a resource is discovered in paragraph 40-730(4)(c) of the ITAA 1997 is merely for the avoidance of doubt as it is part of the ordinary meaning of exploration. It has also been suggested that the Commissioner has administered provisions that preceded paragraph 40-730(4)(c) so as to include economic feasibility studies after discovery of the resource, and to do so must have reflected a view on his part that they were within the ordinary meaning of exploration. It is then said that as the Commissioner considers that the ordinary meaning is relevant in section 37 of the Act, the same approach must apply there.

ATO response to Issue 7

73. Firstly, the Commissioner observes that the relevant concepts of exploration appear in two different Acts and in quite different statutory contexts. For example, while certain feasibility studies are specifically included as exploration or prospecting for income tax (paragraph 40-730(4)(c) of the ITAA 1997), for Petroleum Resource Rent Tax (PRRT) they can come (at least potentially) within paragraph 38(1)(a) of the Act. Also, it may be argued that the specific reference to such studies in paragraph 40-730(4)(c) suggests they are, in fact, beyond the ordinary meaning and do more than avoid doubt. When Division 330 of the ITAA 1997 was enacted as part of the Tax Law Improvement Project, the express reference to such feasibility studies in Division 330 was shown, in the Explanatory Memorandum, as a 'change' to the existing law. No corresponding change was made in the PRRT legislation.

74. Secondly, the fact that the Commissioner accepted for income tax purposes that certain feasibility studies could be treated as exploration or prospecting under predecessor income tax provisions, can say nothing about the correct interpretation to be given to the relevant words in section 37 of the Act.

75. The Tribunal in *ZZGN* considered the relevance of the treatment of exploration expenditure in the ITAAs and concluded that the construction of section 37 of the Act must be discerned from the terms of the Act alone (along with relevant extrinsic materials).[13]

Issue 8: Retention lease guidelines under the *Offshore Petroleum and Greenhouse Gas Storage Act 2006* (OPGGSA) provide an authoritative and consistent guide to determining the commerciality of a discovery and operations and facilities directed at determining commerciality in this fashion is a proper basis for determining whether such operations and facilities are involved in or in connection with exploration for petroleum.

76. Under this view it is also suggested that commercial viability is relevant and regard should be had to the retention lease guidelines whereby, broadly, if commercial viability is established a company cannot obtain or retain a retention lease and must proceed to production (or lose rights over the tenement).

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[11] Taxation Ruling No. IT 2642 *Income tax: mining exploration and prospecting expenditure* (Withdrawn).
[12] Taxation Ruling TR 98/23 *Income tax: mining exploration and prospecting expenditure*
[13] See paragraphs 250, 315 and 378 of *ZZGN*.

ATO response to issue 8

77. Again, this presumes that assessments of commercial viability are relevant to paragraph 37(1)(a) of the Act, and the Commissioner does not accept this proposition.

78. There is nothing to suggest that the application of a regulatory regime was intended to determine the scope of the PRRT exploration concession.[14]

79. In addition, this regulatory regime does not apply to all taxpayers who may be subject to the PRRT.

Issue 9: Society of Petroleum Engineers-Petroleum Resources Management System (SPE-PRMS) Guidelines provide an authoritative and consistent guide to determining the commerciality of a discovery and operations and facilities directed at determining commerciality in this fashion is a proper basis for determining whether such operations and facilities are involved in exploration for petroleum.

80. It has further been argued that the SPE-PRMS Guidelines provide an authoritative, consistent guide to determining the commerciality of a discovery, and such is a proper basis for determining the extent of exploration in its core sense in the Act.

ATO response to issue 9.

81. The SPE-PRMS is a fully integrated system that provides the basis for classification and categorisation of all petroleum reserves and resources.

82. Because no petroleum quantities can be recovered and sold without the installation of (or access to) the appropriate production, processing, and transportation facilities, SPE-PRMS requires accumulations to be related to a particular development project.

83. Reserves may be assigned to a project, if they satisfy the requirements for commerciality as outlined in Section 2.1.2 of the SPE-PRMS. The assessment of commerciality can only be performed at a project level.

84. In all cases, the decision to proceed with a project requires an assessment of future costs, based on an evaluation of the necessary development facilities, to determine the expected financial return from that investment. In this context, the development facilities include all the necessary production, processing, and transportation facilities to enable delivery of petroleum from the accumulation(s) to a product sales point (or to an internal transfer point between upstream operations and midstream/downstream operations). It is these development facilities that define the project because it is the planned investment of the capital costs that is the basis for the financial evaluation of the investment and hence the decision to proceed (or not) with the project. Evaluation of the estimated recoverable sales quantities, and the range of uncertainty in that estimate, will also be key inputs to the financial evaluation, and these can only be based on a defined development project.

[14] See paragraphs 127 and 128 of the draft ruling.

85. According to the SPE-PRMS Guidelines, a discovered petroleum development project is considered commercial and its recoverable quantities are classified as Reserves when its evaluation has established a positive net present value (NPV) and there are no unresolved contingencies to prevent its timely development. If the project's NPV is negative and/or there are unresolved contingencies preventing the project implementation within a reasonable time frame, then technically recoverable quantities must be classified as Contingent Resources.

86. The criteria for commerciality (and hence assigning Reserves to a project) are set out in Section 2.1.2 of the SPE-PRMS.

87. Meeting the 'commercial conditions' includes satisfying the following criteria for classification as Reserves:

- a reasonable assessment of the future economics of such production projects meeting defined investment and operating criteria, such as having a positive NPV at the stipulated hurdle discount rate.
- a reasonable expectation that there is a market for all or at least some sales quantities of production required to justify development.
- evidence that the necessary production and transportation facilities are available or can be made available.
- evidence that legal, contractual, environmental, and other social and economic concerns will allow for the actual implementation of the recovery project evaluated.
- evidence to support a reasonable timetable for development.

88. Where projects do not meet these criteria, similar economic analyses are performed, but the results are classified under Contingent Resources (discovered but not yet commercial) or Prospective Resources (not yet discovered but development projects are defined assuming discovery).

89. Consistent with the SPE-PRMS, the calculation of a project's NPV would reflect, amongst other things, the application of an appropriate discount rate that reasonably reflects the weighted average cost of capital or the minimum acceptable rate of return established and applicable to the entity at the time of the evaluation.

90. The following SPE-PRMS guidance is considered important: 'While each organization may define specific investment criteria, a project is generally considered to be economic if its best estimate (or 2P) case has a positive net present value under the organization's standard discount rate or if at least has a positive undiscounted case flow.[15]'

91. The Commissioner does not dispute the proposition that the SPE-PRMS Guidelines may provide a good guide for determining commercial viability of a discovery, but the Commissioner does not consider that exploration for petroleum under the Act involves the determination of such commercial considerations following discovery.

[15] See 3.1.1 of the SPE-PRMS. The words '(or 2P)' have been included.

Issue 10: Final Investment Decision (FID) is the dividing line between section 37 and section 38 of the Act and that section 38 expenditure cannot occur prior to FID and hence is section 37 expenditure.

92. This view would suggest that, until you have FID, there is no indication that there will be a project. The position would seem to be that general project expenditure cannot be incurred prior to FID as there is no project and no potential project. So, it is only after FID that there can be activities in paragraph 38(1)(a) of the Act that are preparatory to activities in paragraph 38(1)(b) of the Act. This means that the feasibility studies or environmental studies referred to in paragraph 38(1)(a) can only occur after a FID is made.

93. Further, it is asserted that if the feasibility or environmental studies could come within subsection 38(1) of the Act, the exclusion (not exploration) takes it out of section 38 of the Act and puts it in section 37 of the Act.

ATO response to issue 10.

94. The reference to periods before and after the FID is consistent with the concept of a 'phase' approach. That is, that there is an exploration phase, a development phase and an operational phase. The inference is that the FID marks the end of the exploration stage and the start of the development stage. The phase approach presupposes that the character of expenditure can be determined by, or with regard to, the 'phase' in which the expenditure was incurred.

95. The Commissioner does not consider that the 'phase' concept is determinative in establishing the character of the expenditure incurred. 'Phase' is not a concept contained within the Act.[16] Nor is the FID a concept recognised within the Act. The character of the expenditure incurred is determined by a consideration of the nature and purpose of the expenditure. Reference to 'phase' may be a guide to assist in understanding the nature and purpose of the expenditure, but it is not and can not be determinative of the character of the expenditure.

96. Therefore, it does not follow that all expenditure incurred during what is described as the exploration phase must be exploration expenditure. Put another way, the Commissioner does not agree that all expenditure incurred before the development stage (that is before the FID is made) must be exploration expenditure. Nor does the Commissioner accept that general project expenditure can not be incurred prior to the FID being made.

97. It is noted that the Act specifically provides that eligible real expenditure can be incurred *before the project commences* (paragraph 45(1)(a) of the Act). Section 45 creates no distinction between exploration expenditure and general project expenditure when it provides that 'eligible real expenditure' can be incurred before the project commences. Further, augmentation of general project expenditure can occur for many years prior to the project commencing. Hence, it can be said that it is clearly intended that general project expenditure can be incurred prior to a project commencing. It is noted that, for the purpose of the Act, the existence of a project is linked to a production licence.

98. Prior to a production licence being in place, whether expenditure incurred can be said to relate to a particular project or potential project would be a question of fact to be determined by considering the nature and purpose of the expenditure. The Commissioner accepts that before a project commences (that is before a production licence is obtained) or before the FID is taken, there may have been a series of concepts considered, evaluated and eventually discarded before the final concept is identified, accepted and progressed.

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[16] See paragraphs 314 and 319 of *ZZGN*.

99. The fact that a project commences in a form different to that considered in a feasibility study or studies would not, of itself, preclude that expenditure from being seen as expenditure 'preparatory to' the project that eventually emerges.

100. The Commissioner does not accept the view that it is only feasibility or environmental studies that occur after the FID that can fall within paragraph 38(1)(a) of the Act (the implication being that pre-FID studies fall within section 37 of the Act). This view would not, in the Commissioner's view be consistent with the use of the phrase 'including in carrying out any feasibility or environmental study' in paragraph 38(1)(a). If Parliament had intended that only post FID feasibility or environmental studies fall within paragraph 38(1)(a), it is unlikely they would have used the term 'any' to delimit the feasibility and environmental studies intended to be within paragraph 38(1)(a).