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Sent via email: prrt@treasury.gov.au

27 June 2019

Dear Sir/Madam

***Review of the PRRT Gas Transfer Pricing Arrangements***

We would like to thank you for the opportunity to provide a submission in response to the consultation paper *Review of the PRRT Gas Transfer Pricing Arrangements* issued by Treasury on 5 April 2019 (**the consultation paper**).

Attached are our comments to specific questions raised within the consultation paper and a summary of our responses. Our focus in this submission primarily relates to a consideration of the Comparable Uncontrolled Price (**CUP**) approach to pricing gas at the taxing point and the application of other arm's length principles.

In our view, no changes should be made to the current Regulations as they continue to reflect the most appropriate approach to pricing gas at the taxing point.

We note that any changes to the current Regulations must be carefully considered and if implemented, must only be done on a prospective basis for new projects.

If you have any queries in relation to our submission, please contact me on [REDACTED] or Emily Falcke on [REDACTED].

Yours faithfully

A handwritten signature in black ink, appearing to read 'Janelle O'Hare', written in a cursive style.

Janelle O'Hare  
Partner  
Tax & Legal



## Submission

### *Summary*

Our key conclusions can be summarised as follows:

1. Currently there are no observable third party transactions that could be considered comparable transactions. The conditions necessary to establish a CUP for feedstock gas used in vertically integrated operations do not exist.
2. To the extent comparable transactions may exist in the future, the requirements of the existing CUP rules in the Regulations are appropriate to ensure that such transactions are sufficiently comparable to establish an arm's length price.
3. There should be no relaxation of the CUP requirements in the Regulations in order to try and create the conditions for a CUP to exist.

Our comments relevant to specific questions are set out in further detail below.

### ***Question 1: What principles should underpin the price of feedstock gas in vertically integrated operations going forward?***

In our view, the principles that should underpin determining the price of gas in a vertically integrated gas to liquid (GTL) operation going forward remain the same as those on which the current Regulations are based.

At its core, the requirement in the PRRT Act is that the price must reflect an arm's length price. As such, we consider the relevant principles to be applied include:

- The Regulations must reflect arm's length principles pursuant to generally accepted international standards.
- The pricing approach should result in a price outcome which is reflective of the investment made, assets utilised, risk borne and costs incurred by the specific project.
- The upstream and downstream businesses carry the same level of risk and expect the same returns.
- Ultimately the transfer price should be capable of measurement, as well as be transparent, equitable and simple to administer for both taxpayers and tax administrators. In this regard, the Callaghan review notes that changing the valuation method for sales gas away from the RPM may present greater challenges in this regard.<sup>1</sup>
- Consideration should be given to the importance of economic stability and project forecasting for investors when considering the feasibility of investments and/or projects.

### ***Question 2: Are the CUP rules too restrictive, even if there was a scenario where a CUP is identifiable?***

In answering this question, it is relevant to have regard to the rules contained in the Regulations as well as the Organisation for Economic Co-operation and Development (OECD) Guidelines<sup>2</sup> relevant to a CUP.

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<sup>1</sup> Page 93 of Callaghan Report

<sup>2</sup> OECD (2017), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, OECD Publishing, Paris. <http://dx.doi.org/10.1787/tpg-2017-en>



## **2.1. Current Regulations**

In an integrated GTL operation to which the Regulations apply, petroleum is processed into “sales gas”<sup>3</sup>, which is then processed into a liquefied product i.e. LNG.<sup>4</sup>

Where there is no arm’s length sale of sales gas at a point within an integrated GTL operation, the Regulations are applied to determine the arm’s length price (and therefore the assessable receipts for the purpose of section 24 of the PRRT Act) of the sales gas at the taxing point. The Regulations can also apply to determine an arm’s length price for natural gas sold in a non-arm’s length transaction for use in an integrated GTL operation.

A non-arm’s length transaction is defined for these purposes as a transaction where the Commissioner, having regard to any connection between the parties to the transaction or to any other relevant circumstances, is satisfied that the parties to the transaction are not dealing with each other at arm’s length in relation to the transaction.<sup>5</sup>

Where sales gas of the integrated GTL operation is the subject of a non arm’s length sale, the assessable petroleum receipts are determined by applying section 19 of the Regulations. If sales gas is not sold but rather processed into a liquefied product, section 20 of the Regulations is used to determine the assessable receipts.

Under both scenarios, the assessable receipts are determined as follows:

1. If an Advance Pricing Arrangement (**APA**) applies, the assessable receipts are calculated in accordance with the APA.
2. If there is no APA, but there is a CUP, the CUP is applied to determine the assessable receipts.
3. Where there is no APA and no CUP, the Residual Pricing Method (**RPM**) price must be used.

A CUP is specifically defined for these purposes in section 23 of the Regulations as follows:

1. *A comparable uncontrolled price, or CUP, in relation to a relevant transaction for a volume or mass of project sales gas, is a price for sales gas:*
  - a) *that was obtained for a sale in a market that the Commissioner is satisfied is a relevant market in relation to the transaction; and*
  - b) *that the Commissioner is satisfied is an observable arm’s length price.*
2. *A comparable uncontrolled price, or CUP, in relation to a sale of a volume or mass of project natural gas to which paragraph 24(1)(f) of the Act applies, is a price for natural gas:*
  - a) *that was obtained for a sale in a market that the Commissioner is satisfied is a relevant market in relation to the transaction; and*
  - b) *that the Commissioner is satisfied is an observable arm’s length price.*

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<sup>3</sup> As defined in section 2 of the PRRT Act 1987

<sup>4</sup> Section 6(1) of the Regulations

<sup>5</sup> Subsection 24A(2) of PRRT Act 1987



3. *In determining whether a market is relevant, the demand and supply characteristics of the market must be taken into account, including:*
  - a) *the composition of sales gas or natural gas sold in the market; and*
  - b) *geographic differences between the production facilities and the product delivery point of the sales gas or natural gas sold in the market; and*
  - c) *the end use for the sales gas or natural gas sold in the market.*

*Example: Retail, wholesale, manufacturing, feedstock, domestic.*
4. *In determining whether a market is relevant, the following factors must also be taken into account:*
  - a) *the terms of contracts usual in the market, including volumes, discounts, exchange exposures and other relevant conditions that would reasonably be considered to affect the price;*
  - b) *market strategies;*
  - c) *the existence of spot sales (including market penetration sales) below or above marginal cost;*
  - d) *processing costs;*
  - e) *technology used in processing;*
  - f) *any other factors that it would be reasonable to consider.*

To summarise, if applying the CUP per the Regulations to determine the gas transfer price (**GTP**) at the taxing point, the price to be used is an amount equal to the price for the natural gas or sales gas that:

- i) was obtained for a sales in a relevant market, and
- ii) is an observable arm's length price.

The Regulations then go on to prescribe certain factors that must be taken into account when determining whether a market is a relevant market. What is provided is **not** an exhaustive list and there is no order of priority or weighting within the facts and circumstances to be considered. Further, there is no explicit optionality made within the Regulations that if there is a difference which could be easily and reliably quantified and adjusted that this adjustment be made.

In our view the CUP rules in the Regulations do have sufficient flexibility to enable a range of factors to be considered when determining whether a market is a relevant market. What is set out is a list of the factors that must be considered, but not to the exclusion of other relevant factors.

It is also relevant to note the factors to be considered under the Regulations are consistent with those that would need to be considered when carrying out a comparability analysis using OECD Guidelines, among others. In our view it is possible, and relevant, under the Regulations to consider whether the OECD Guidelines in relation to CUPs can provide further guidance in these circumstances.

The OECD Guidelines are considered further below.

## **2.2. OECD Guidelines**

The OECD Guidelines set out internationally accepted principles and methodologies applied between related parties entering into dealings with each other to determine or support what independent parties would do (or the price they would charge) in the same or similar circumstances.



The OECD Guidelines provide five generally accepted pricing methodologies which can be considered and applied. These are:

1. The CUP method
2. The Resale price method
3. The Cost Plus method
4. The Profit Split method, and
5. The Transaction Net Margin method.

Each method has its own relative strengths and weaknesses and, while there is no hierarchy under the OECD Guidelines<sup>6</sup>, where a CUP is available for application it is considered to give the most reliable and direct price comparison.<sup>7</sup>

Focusing on the CUP method as the Regulations refer specifically to a CUP, it determines an arm's length price by reference to the amount charged in comparable uncontrolled transactions under similar circumstances. There are two types of CUPs:

1. External CUPs are prices for transactions between two independent external parties in which the property transacted and circumstances of the transaction are very similar or identical to the property and circumstances of the controlled transaction (otherwise referred to as a tested transaction or, in this case, the GTP).
2. Internal CUPs are prices for transactions entered into internally but with an external independent party in which the property transacted and circumstances of the transaction are very similar or identical to the property and circumstances of the controlled transaction (i.e. the tested transaction or GTP).

An example of an external CUP could be a sale between two external independent parties for which public information is available, or from the use of public databases and quoted pricing. However, quoted pricing is often for a specific product with specific contract terms which may require adjustment, or a quoted price may not be available for the product under review, e.g. LNG feedstock.

An internal CUP is often more likely to give a perfect comparison as there is a higher likelihood that the underlying product being sold is identical. However, there may be only limited internal CUPs available or the terms of the contract may be different.

Under the OECD Guidelines, applying a CUP requires close comparability between the two dealings in terms of each of the relevant comparability factors, including:

- Nature of the product/service
- Functions performed, assets utilised and risks assumed by each of the parties
- Contractual terms
- Economic circumstances, and
- Business strategies.

While it may be obvious that there should be a match for the underlying product, it is also important to consider:

- The market for which the product is intended (e.g. for use in LNG to export, domestic gas sales, future domestic LNG sales or electricity production)
- Volumes sold

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<sup>6</sup> OECD Guidelines, paragraph 2.2

<sup>7</sup> OECD Guidelines, paragraph 2.15

- The terms of the transaction (e.g. basis of pricing, shipping terms or credit terms)
- The point in time of the transaction both by date but also with reference to the lifecycle of a project
- The physical point in the integrated supply chain at which the sale is made, and
- The relative bargaining positions of the parties at the time of the dealing (e.g. a one off sale to supplement LNG production or a long term feedstock arrangement).

The OECD Guidelines state that a comparable uncontrolled transaction will exist for the purposes of the CUP method where none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price in the open market, or to the extent such differences exist, reasonably accurate adjustments can be made to eliminate the material effects of such differences.<sup>8</sup> The extent and reliability of any such adjustments will affect the relative reliability of the CUP.

The OECD Guidelines also include relevant commentary on the application of a CUP in pricing commodity dealings at paragraphs 2.18 to 2.22. Some of the relevant guidance includes:

- It is considered that the CUP method would generally be an appropriate transfer pricing method for establishing the arm's length price for the transfer of commodities.
- Quoted commodity prices generally reflect the agreement between independent buyers and sellers in the market on the price for a specific type and amount of commodity, traded under specific conditions at a certain point in time.
- A relevant factor in determining the appropriateness of using a quoted price is the extent to which the quoted price is widely and routinely used in the ordinary course of business in the industry to negotiate prices for uncontrolled transactions comparable to the controlled transaction.
- Taxpayers and tax administrations should be consistent in their application of the appropriately selected quoted price.

### **2.3. Practical application of a CUP for the GTP**

As can be seen in the theoretical requirements set out by the OECD, it can be very difficult to find a reliable CUP.<sup>9</sup>

This restriction or limitation to the application of a CUP is important to the integrity of the OECD Guidelines. As a CUP applies a price directly to a specific product it is important that the characteristics of that product, and of the dealing in which the price has been set, match the circumstances being priced to allow for a reliable comparison.

However as noted above, it is possible when applying the OECD Guidelines to make adjustments to a potential CUP. If a potential CUP is available and adjustments can be identified and quantified, then this is already a valid application of the CUP methodology.

At a practical level, when the OECD Guidelines are considered and applied (for example in a transfer pricing context), specific consideration would be given first to the similarity of the product (e.g. specification and quantum), then to contract terms (e.g. timing, financing). Generally, if a material difference in one of these terms is identified it is more likely to mean that a CUP does not exist.

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<sup>8</sup> OECD Guidelines, paras 2.2 and 2.15

<sup>9</sup> This has been recognised in the consultation paper through the references to the 2001 Explanatory materials to the *Taxation Laws Amendment Bill (no. 6) 2001*.



Alternatively, it is generally these terms which can be reliably quantified and an adjustment potentially made where the requisite level of similarity exists.

Other points of comparability would also be considered:

- Business strategies of the parties (e.g. foundation customers, market penetration, state owned enterprise)
- Lifecycle of the production project (e.g. commissioning cargoes)
- The level in the market of the buyer (e.g. a global portfolio trader vs end user vs on-seller)
- Location of the buyer
- The contracting or buying approach of the purchaser (e.g. long term, mi- term or spot sales contracting; the preference of a buyer to purchase wet gas due to the other components of the gas; and while no longer covered by PRRT, LNG produced from coal seam gas, referred to as super lean, has a different energy content to LNG produced from wet gas even where the other components have been stripped down, which can be considered a benefit to some buyers but not others, therefore creating difficulty in comparing products from different projects.)

Each of these factors should be considered individually and as a combination. The existence of a difference in one of these factors may be determined as not materially affecting price, but two, three or four differences may be cumulatively considered as no longer allowing for a reliable CUP. It should be noted that it is also often more difficult to reliably quantify adjustments as a result of one of these more qualitative differences.

Therefore, in our view it is very difficult to make reliable adjustments within a highly complex, vertically integrated production supply chain such as an integrated GTL operation. For example, where there may be sales at a point prior to the LNG production, these are often on different terms or volumes which can mean it is very difficult to quantify a reliable adjustment.

To further illustrate this point, an example was provided in the Callaghan Review<sup>10</sup> that in considering the East Coast onshore projects, there was a potentially clearer link between the LNG feedstock gas and the domestic gas sales. While the onshore projects have now been removed from the PRRT regime, it remains relevant to note that any potential application of the domestic gas price as a CUP for LNG feedstock would need to consider and apply each of the above factors in detail. The volatility and current drivers in the domestic gas market could very well be considered sufficiently different such that no CUP could be established and no reliable adjustments made.

Ultimately, given the nature of the Australian oil and gas industry (particularly the geographic and market differences), identifying a CUP and adjusting it reliably seems almost impossible and unlikely in the near future. However, as previously noted, the industry has changed substantially in recent times, and it may be that further changes in the future will create opportunities for the CUP method to be considered.

#### **2.4. Conclusion - are the current CUP rules too restrictive?**

As a core principle, it is essential that any methodology used for determining the price of sales gas reflects an appropriate arm's length price for gas at the taxing point. In the context of applying a CUP, we consider this means that transactions must be sufficiently comparable to be able to be used. Accordingly, it is necessary for high standards of comparability to be applied in assessing the applicability of a CUP to ensure the resulting price is appropriate.

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<sup>10</sup> At page 90



In our view in the current market there are still no observable third party transactions that could be considered under any circumstances to be comparable for these purposes. Accordingly, regardless of how the CUP rules in the Regulations are drafted there no meaningful transactions that currently exist now or that are foreseeable in the near future that could in any circumstances give rise to an arm's length price.

However, to the extent comparable transactions may exist in the future, we consider that the rules are appropriate to ensure that any such transactions are sufficiently comparable such that an arm's length price can be calculated.

Specifically we note that there should be no relaxation of the CUP requirements in Regulation 23 in order to try and create the conditions for a CUP to exist where it would not otherwise when applying general arm's length principles. To do so would enable the Commissioner to apply a GTP based on the price of a transaction that is not a meaningful CUP (as that arm's length methodology is defined for OECD purposes).

Any such outcome would not be aligned with the arm's length principle being applied for these purposes, which as stated in Question 1, is critical to the principles which should underpin the pricing of feedstock in an integrated GTL project.

***Question 3: In what way could the CUP rules be revised in order to provide greater flexibility to use arm's length prices to derive a CUP as new commercial arrangements arise?***

As noted and recognised throughout the process of review of the PRRT regime, the industry has changed significantly. Maintaining the potential availability to apply a CUP in the future is recognised as a positive step to future-proof the regime and provide flexibility should potential CUPs become available.

We do not consider there needs to be any change to the CUP rules as set out in the Regulations as they provide sufficient flexibility to be used to determine arm's length prices to the extent new commercial arrangements arise.

It could be considered whether the application of a CUP to determine the GTP in the Regulations be made explicitly consistent with that put forward in the OECD Guidelines. Adopting a CUP applied in accordance with the OECD Guidelines will, in our view, maintain the integrity of the CUP prices applied. The application of a CUP in accordance with the OECD Guidelines allows for reliable, reasonable adjustments to be made where differences can be quantified.

Some consideration is given by the Callaghan Review to the use of an industry wide CUP. While it may be considered that this could provide certainty to investors on the potential PRRT obligations, it would not allow for the relative investments made within different projects to be reflected within the underlying PRRT obligations. This may have the unintended impact of discouraging investment, particularly in deeply technical and expensive upstream operations.





***Question 4: How could the OECD Guidelines be best used to inform an arm's length outcome in the gas transfer pricing regime?***

As recognised in the consultation paper, the overall objective of the GTP regime is to estimate an arm's length price of the feedstock gas.<sup>11</sup> In the same section of the consultation paper, it is acknowledged that this is the intention and purpose of the OECD Guidelines.<sup>12</sup>

While considerable time has been spent above and in other PRRT documents considering the relative applicability of the CUP method, it should be noted that the OECD Guidelines provide a number of different arm's length pricing methods which could be applied.

When considering the other methods contained within the OECD Guidelines, it is noted that the Resale Price, Cost Plus and Transactional Net Margin methods are considered to be more simplistic, one-sided pricing approaches, which in our view are not appropriate for determining pricing in a complex integrated supply chain.

However, the profit split method is appropriate for this purpose.<sup>13</sup> The profit split method considers the relative contributions of each party in an integrated arrangement to determine routine returns that should be allocated to each party (or part) of the integrated arrangement. Any residual is then allocated between the two based on a consideration of each parties relative contributions or un-valued activities. From a transfer pricing perspective, we consider that the RPM represents a formulaic approach to the profit split method.

From a practical perspective the application of a "free-form" profit split is unlikely to be a more efficient or appropriate solution, either for industry participants and regulators. The cost of implementation and maintenance to the industry participants, and the cost and effort in undertaking reviews and audits to provide assurance regarding the application of multiple profit splits would be prohibitive to all involved.

In any event, to the extent a profit split is considered by a taxpayer, this could currently be negotiated through the first pricing approach available, the APA.

***Question 14: How can the current profit split be changed to better allocate returns in circumstances where the price of the LNG resource is high?***

In our view, a residual profit split of 50/50 under the RPM is the most reliable, consistent way to seek to approach the allocation of returns between the upstream and the downstream phases of an integrated GTL project. This most appropriately reflects the fully integrated nature of such projects whilst delivering a simple, consistent method capable of application by taxpayers and review by the ATO.

***Question 19: Comments are invited on any revisions that would be beneficial to consider with regard to APAs?***

The existing APA process can be a complicated, expensive and time consuming process. The agreement lasts for a limited period of time and needs to be consistently renegotiated with the ATO

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<sup>11</sup> OECD Guidelines, paragraph 35

<sup>12</sup> OECD Guidelines, paragraphs 31 to 35

<sup>13</sup> OECD Guidelines, paragraph 2.115



over the long life of such projects. In our experience, the outcomes are not generally agreed on a timely basis, meaning taxpayers are operating with ongoing uncertainty for an extended period of time.

A streamlined APA could be a useful alternative to be made available to taxpayers seeking to agree certain methodologies or pricing approaches.

***Question 20: Comments are invited on the ease of complying with each of the methods in the regulations, and any changes that should be considered that achieve greater public transparency or greater simplicity.***

The application of transfer pricing principles is never simple. That is why in our opinion the RPM, which provides a statutory formula, is the method that provides the greatest transparency and simplicity for what is a complicated issue.

Other transfer pricing methodologies could be applied in practice, such as a CUP to the extent any become available or a profit split, however this reduces the transparency associated with the calculation of revenue and adds complexity for the regulator in its administration.

***Question 22: Should businesses be required to publicly report on the price of gas at the taxing point? What other practical options are there to improve transparency that the PRRT is delivering a fair return on resources to the Australian community?***

In our view, such a requirement would impose an unfair and disproportionate burden on taxpayers with an interest in an integrated GTL project. No other taxpayers are required to disclose such details relevant to sensitive commercial aspects of their business and it would be unfair for such a requirement to be placed on a limited number of taxpayers in the oil and gas industry.

The issue as to whether the PRRT is delivering a fair return on resources to the Australian community is one that has been considered in various public hearings and reviews, the most recent of which was the Callaghan review. This review found that:

*...while the PRRT remains the preferred way to achieve a fair return to the community for the extraction of petroleum resources without discouraging investment, changes should be made to PRRT arrangements to make them more compatible with the developments that have taken place in the Australian oil and gas industry.*

*In considering the extent and timing of any changes to the PRRT, however, allowance has to be made for the very large recent investment in the Australian petroleum sector on the basis of long-standing taxation arrangements. The overall stability of the PRRT has contributed to this large investment. Given the range of uncertainties involved in large, long-term petroleum investments, stability in fiscal settings is an important factor influencing a country's investment attractiveness. Moreover any substantial change to the PRRT should be the outcome of a considered, comprehensive and consultative process.*

*Consequently, the Report's recommendations are in two parts. First, a process to update the design of the PRRT with resulting changes only applying to new projects (as defined in the PRRT legislation) from a date to be specified. Second, changes to improve the integrity, efficiency and administration of the PRRT that should apply to existing and new PRRT projects.*



The 12 recommendations made in the Callaghan report are all being addressed by the Government.<sup>14</sup> In our opinion, this, together the publication made by the Commissioner of annual PRRT payments made by taxpayers, should provide sufficient transparency and certainty that the PRRT is delivering a fair return to the Australian community.

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<sup>14</sup> 2 November 2018, *Government response to the Petroleum Resource Rent Tax Review*, available online at: <https://treasury.gov.au/publication/p2015-t339508>