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AFTS Secretariat
The Treasury
Langton Crescent
Parkes ACT 2600

29 April 2009

Dear Sir,

Review of Australia's Future Tax System

In response to the request for submissions, Shell is pleased to take this opportunity to make a submission on key matters of interest to it in ensuring Australia's long term fiscal competitiveness.

The focus of this submission is on addressing one of the key questions raised in the consultation paper *"Can the tax system be structured to better attract investment to Australia in a way that increases national income, and if so how?"*

Shell believes by maintaining a stable and competitive taxation regime that supports the development of major resource projects, such an outcome is possible.

Creating national income by attracting investment

Shell's major activities in Australia include the refining, distribution and marketing of petroleum products, and the exploration and development of oil and gas resources, particularly large scale Liquefied Natural Gas (LNG) projects.

Shell's downstream refining, distribution and marketing business is of strategic importance, supplying around 25% of Australia's transport fuels. This business is in the mature phase of its lifecycle with limited growth prospects. New investment is generally focused on maintaining current levels of production or improving fuel quality rather, than capacity expansion.

By contrast, the potential new investment in Shell's LNG business in Australia is very large. Shell is a participant in the North West Shelf LNG Joint Venture, a significant shareholder in Woodside, a major holder of discovered gas resources in Australia and an active participant in the exploration for new gas resources. Shell sees potential to grow its current equity share LNG production of around 2.5 million tonnes per annum (mtpa) to around 15 mtpa over the next 10-15 years. Achieving this growth would require Shell to invest tens of billions of dollars to develop these LNG projects, which in turn would generate considerable national income and tax revenues. APPEA estimates that a typical

2 train LNG development delivers in NPV terms $40 billion in tax revenue over its 25 year life.

Attracting the investment to achieve this growth potential will not be easy as Australia has to compete for capital in what is truly a global market. Australia has a number of attractions as a potential site for LNG developments including a significant gas resource base, a stable political and fiscal regime which welcomes investment in major resource projects and proximity to major markets in the Asia Pacific region. Offsetting these advantages are the remote and deep water location of Australia's gas resources which makes them difficult and very expensive to develop. The extent of the challenges in developing these very large LNG projects is evidenced by the fact that many of Australia's major gas discoveries such as Gorgon, Sunrise and Browse have not been developed despite having been discovered in the 1970s and 1980s.

Although there are many factors that influence the decision to proceed with these mega projects which can cost tens of billions of dollars, a stable and competitive fiscal regime is an important factor in the global ranking of investment opportunities.

Recommendations

Shell believes there are three areas in which modifications to the Australian tax system would make it more internationally competitive and therefore attract additional investment:

1. Ensuring fiscal stability.
2. An improved capital allowances regime.
3. Tax treatment of restructuring activity in the oil and gas sector.

While these three proposals are complementary, Shell believes that ensuring fiscal stability is of paramount importance.

Ensuring Fiscal Stability

Australia has a well deserved reputation as a country with low sovereign risk and a relatively predictable and stable fiscal environment. This has been a major competitive advantage in attracting investment in major resource projects to Australia. Such stability is particularly important for LNG projects as they:

- require upfront capital expenditure of tens of billions of dollars;
- have a project life which can be over 40 years; and
- have contractual customer commitments which can be over 20 years.

Changes to the fiscal arrangements after the up-front investment has taken place can fundamentally alter the economic viability of projects. Equally importantly, such changes can also alter the perceptions of risk associated with future investments with the potential consequence that new investment opportunities are lost to Australia which reduce both

national income and tax revenues. Ensuring fiscal stability is of paramount importance in attracting new investment to Australia. If investors do not have long term confidence in the stability of the tax regime, potential investments in major projects will be severely compromised.

Australia's strong reputation for fiscal stability in the taxation of major resource projects has been negatively affected in recent times. Examples of this include:

1. the decision of the Australian Government to remove the long standing exemption from excise taxes for condensate produced in the North West Shelf which was announced in the 2008 budget;
2. the decision by the Australian Tax Office to change the long standing practice applied to the North West Shelf project of allowing the aggregation of petroleum accumulations within the project area for taxation purposes; and
3. Challenge by the Australian Tax Office to the ability to rely on the safe harbor limit in the thin capitalisation rules where foreign related party debt is used.

While Shell recognises and respects the right of the Australian Government to set and adjust the fiscal environment, it is very important that the long term nature of investments such as LNG projects is recognised as part of that process. A practical means of ensuring this is by ensuring that any fiscal changes are "grandfathered" so that they only apply to future investments. The "grandfathering" approach has been effectively applied in other areas of the fiscal law, a recent example being the introduction of new rules applying to financial arrangements. Such an approach would significantly reduce the perception of risk associated with the potential changes to the tax regime and would enhance the attractiveness of Australia as an investment location.

In addition to formally "grandfathering" tax arrangements for major projects, the adoption of a more transparent and cooperative relationship between industry and the Australian Tax Office would also help industry to build mutual understanding. This should assist industry in building confidence in the stability of the tax system as it applies to major projects.

An improved capital allowances regime

The LNG industry is one of Australia's most capital intensive sectors. New projects involve capital expenditure of tens of billions of dollars and there is typically a long lag until projects become cash positive, let alone produce an appropriate rate of return on the capital investment. This unique nature of LNG investments needs to be factored into relevant fiscal settings.

APPEA commissioned Wood Mackenzie, an energy research and consulting firm, to determine why many of the largest gas discoveries in the world, which have been discovered in Australia, remain undeveloped. The conclusion was that the main impediment to investment is the capital allowances regime. The report stated:

"... the economics of large gas discoveries continue to appear marginal to investors, even when oil prices are high. While securing a high gas price will remain the investor's primary objective, the Government may wish to consider reducing its take from large gas projects, if it wishes to stimulate development of its gas resources. The most obvious element to review would be the federal income tax depreciation schedule, which appears anomalously slow in comparison to fiscal regimes elsewhere."

Under current rules, capital costs are generally depreciated over a 15-20 year period. Wood Mackenzie reported that this is among the slowest of depreciation write-off periods for upstream capital expenditure when compared with other countries with whom Australia competes for capital.

Under the current rules, the application of slow depreciation rates for large projects means that tax becomes payable long before the investor has recovered its capital costs or achieved a return on investment.

Shell recommends that the Australian tax system relating to LNG projects be changed by implementing a more competitive statutory cap on asset lives for assets associated with gas production, liquefaction activities and related greenhouse gas storage processes. Such a change would make no difference to tax collections by the Government over the life of a project. However, such a reduction can have a marked impact on investment decisions, which place a heavy emphasis on the time value of money. Making the Australian tax system more internationally competitive in this way creates potential to attract additional investment and generate additional national income and tax revenues, while at the same time not losing any tax revenues on a particular project.

Tax treatment of restructuring activity in the oil and gas sector.

Oil and gas projects are typically undertaken by joint ventures. This largely reflects the considerable cost of developing such projects and the desire of those involved to share the risks and rewards. The structure of joint ventures often changes as the project moves through its lifecycle.

Examples of such restructuring include:

- Some joint venture participants selling down their interest in order to bring other parties with particular skills or financial capacity into the joint venture.
- Joint venture participants exchanging ownership in different fields which make up a project in order to align their interests across the broader project area.

Such restructuring leads to ownership by those with the greatest interest, resources or expertise, and therefore helps to achieve the government's objective of encouraging the most efficient development of the industry in a timely manner. However, such restructuring can incur tax penalties, even where there is no change in the net asset position of the parties involved. Examples of this include the application of capital gains tax and stamp duty. The application of these taxes creates a disincentive to restructure joint venture arrangements in order to promote a more efficient structure.

Shell recommends that elective replacement asset rollover be allowed to facilitate such restructuring. This would involve only imposing capital gains tax on the net change in asset positions within a joint venture and applying a CGT exemption if funds received due to such restructuring were reinvested within a nominated period.

To be effective, it would also be necessary to ensure that the States and Territories enacted similar measures to shelter such transactions from any transaction duty.

There is precedent for such a rollover, both within Australia and overseas. In Australia, a replacement asset CGT rollover exists for small businesses. This is not restricted to particular assets or industries. In the UK, a reform package was announced in this year's Budget, on 22 April, to specifically deal with these issues. Included in these reforms was the introduction of a concession with respect to North Sea asset transfers. Effective on assets sales after the announcement, if proceeds from an asset sale are reinvested in the North Sea, gains on the asset sale will be exempt from tax. Furthermore, asset swaps will also be exempt from tax.

The exchange of assets may also trigger a change in business activities and therefore result in the elimination of carry forward tax losses for the parties to the exchange. Accordingly, it is recommended that the same business test (SBT) be modified to provide that the test is not failed by virtue of an exchange that qualifies for rollover relief and that, for the purposes of testing the SBT from that point in time, it should be by reference to the business carried on immediately after the rollover occurs. This would reflect the true nature of the SBT as an anti-avoidance provision rather than one intended to catch ordinary commercial transactions.

Way forward

Shell appreciates this opportunity to provide feedback on the tax system from the investor's standpoint, and looks forward to continuing an open and constructive dialogue on these issues. We would be pleased to provide clarification or further details of any of the matters raised in this letter at any time during the course of your deliberations.

Yours faithfully

Russell Caplan
Chairman
Shell Companies in Australia