Review of the Fiscal Regime for Mining and Petroleum Projects in Papua New Guinea

Oil Search Submission to Tax Review Committee

31st May 2014

HEAD OFFICE
Ground Floor, Credit House, Cuthbertson Street, Port Moresby, Papua New Guinea
PO Box 842, Port Moresby, NCD 121, Papua New Guinea
Telephone: (675) 322 5599  Fax: (675) 322 5566 / 322 5588
www.oilsearch.com

This paper contains the response from Oil Search Limited to the Papua New Guinea Taxation Review Issues
Paper No.1: Mining and Petroleum Taxation
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Foreword

As I write this, Papua New Guinea is on the cusp of entering an elite club of Liquefied Natural Gas exporting countries. PNG has demonstrated once again that it is capable of delivering world class resource projects ahead of schedule. This reputation has been hard-earned and had it not been for the foundation that has been laid over the last 20 years, today’s achievements would not have been possible.

The industrialization achieved by the Western world over a few hundred years has been delivered by Papua New Guinea in 39 years. What a journey it has been!

But PNG is once again at the crossroads. Oil Search’s future is inextricably tied to Papua New Guinea’s future. PNG’s future is Oil Search’s future. We know what it takes to become a successful publicly listed company in Papua New Guinea and what it takes for Papua New Guinea to continue to be a world class investment destination of choice.

I commend this Submission to you in the hope that it will form the basis for constructive, open and honest dialogue on the fiscal architecture of our country. The objective being that we can sustain the extraordinary growth that has been the hallmark of recent years and secure the futures of the subsequent generations of citizens of this nation.

....................................................

Peter Botten
Managing Director
Section 1: Introduction

The Papua New Guinea (“PNG”) Tax Review is an important step in dealing with important fiscal and regulatory issues such as the efficiency of the tax system and international competitiveness of the petroleum taxation regime. The significance of the current review is highlighted by the fact that the last major fiscal policy change occurred in the mid-90s when the PNG Government introduced a new fiscal and regulatory regime for the commercialisation of gas resources. The new fiscal regime introduced in the 1990s and its further review and endorsement by the Bogan Committee in year 2000 paved the way for the successful delivery of the US$19 billion PNG LNG Project.

Oil Search, a company that is proud to have been operating in Papua New Guinea since 1929, fully supports the current review and is confident it will further strengthen the fiscal and regulatory foundation and thus facilitate the timely delivery of the next phase of gas growth that can sustainably fuel the next wave of economic development in PNG.

The petroleum industry has contributed over Kina 13 billion in taxes, landowner payments and corporate contributions over the life of the current projects. Oil Search has made substantial contributions to the economic welfare of PNG, as detailed below, and envisages continued growth in the Company’s contribution as the PNG LNG Project moves into production operations.

<table>
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<tr>
<th>Payments to PNG Government ^^</th>
<th>2011 ($US,000’s)</th>
<th>2012 ($US,000’s)</th>
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<td>Payments to State owned enterprises</td>
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**Figure 1 Oil Search Contribution over the last 3 years**

^^ Net of TCS

*Spent on behalf of the Government, out of the amounts payable as tax

** includes 3rd party donations

In our view, the PNG fiscal regime as it applies to the broader resource sector is already well-balanced and fundamental reform is not required. PNG already sits around the mid-point in terms of its total Government take from resource projects when compared to other comparable jurisdictions and, given the inherent challenges of undertaking large capital projects in the country, there is a real
risk that any reform which increases the Government take will materially decrease the attractiveness of PNG as a global petroleum investment destination. With respect to international petroleum characteristics, the nature of PNG geology, topography and the lack of infrastructure make the country a high cost environment. PNG has already seen declines in production, exploration and profitability of resource projects in recent times, particularly in the mining sector. Given that resources currently make up more than two-thirds of PNG’s exports, any further decrease in investment in resource projects could erode the economic outlook of PNG.

Oil Search encourages the Government to utilise this opportunity to examine how the benefits derived by Government from resource projects are most effectively and efficiently distributed to the people of PNG. In particular, Oil Search supports the Government in—

- considering how to meet the infrastructure delivery challenge; and
- the achievement of the goals in the Strategic Focus Areas outlined in Vision 2050.

Oil Search has worked collaboratively with the Government and the LNG Operator in developing a Shared Responsibility Model (SRM) for benefits management and project delivery. The institutional framework and governance mechanism under the SRM allows Oil Search and Exxon Mobil to work with the State and the provincial governments from project identification, endorsement, funds management to project management, delivery and reporting. The provinces identify the projects, the State through the Expenditure Implementation Committee (EIC) approves the projects and the LNG Operator and the Oil Operator deliver these projects with the assistance of landowner companies. As part of institutional capacity building, five Infrastructure Development Units (IDUs) have been set up in each of the affected provinces and a National Programme Management Unit (NPMU) set up at the Department of National Planning and Monitoring to provide overall coordination. Both IDUs and NPMU are fully funded from the project budgets and are co-staffed by Oil Search and Exxon Mobil alongside the provincial and State officials.

The SRM has been approved by the National Executive Council and endorsed by the EIC. Currently, the SRM covers the remainder of the Infrastructure Development Grants of K1.2 billion and the High Impact Infrastructure Projects of K460 million. Oil Search submits that the SRM is a significant step towards developing institutional capacity and governance framework for benefits management and project delivery. We urge that the Government adheres to the SRM framework and, in due course, expand its scope to include other benefits such as Development Levy. Oil Search suggests that the Committee provides suitable recommendations to the Government on criticality of the benefits management and as an important adjunct to the fiscal regime as they complement each other in the furtherance of economic development aspirations of the nation.

This Oil Search submission addresses the issues contained in the Tax Review Committee’s Issues Paper No.1: Mining and Petroleum Taxation and has also raised several other policy issues not considered in the Paper. As PNG’s largest listed company and long term contributor to the country’s development, we have a great willingness to work with all levels of Government and with the communities in which we operate to ensure the future prosperity of PNG. We look forward to working with the Tax Review Committee and exchanging views on potential reforms as part of developing a balanced taxation regime for PNG.
Section 2: Executive Summary

Oil Search considers the current tax review vital to providing the platform for the next phase of gas growth in PNG in the same way that the Gas Policy White Paper (1996) and the Bogan Review (2000) facilitated the US$19 billion PNG LNG Project.

PNG’s geological prospectivity and the relative high cost environment are important elements in a consideration of what is the appropriate level of State take from resource projects. The developer spends significant sums of money upfront to provide infrastructure and community services which would otherwise have been provided by national and sub national Government. In the context of this operating environment, and with the threat of significant supply competition in the Asia Pacific LNG market, it is difficult to justify any material increase in State take, if the Government is committed to the future growth of the LNG industry.

We submit that the equitable distribution of benefits derived from the exploitation of mineral resources, the management of benefits and effective project and services delivery are as important as having a reasonable share of the economic surplus. From our experience, significant effort by Government, industry, regional and local governments, civil society and landowners needs to be focussed upon managing the benefits for sustained economic development and the efficient delivery of community and infrastructure projects.

We consider the landowners and provincial/local level government to be important project partners. We support the Government in its assignment of a significant stream of benefits to these stakeholders to help deliver tangible economic development in the project areas. We continue to offer our support in building institutional capacity and in the meantime by helping to deliver meaningful projects. In our view, the Committee should consider and assess the balance between the benefits accruing to the project impact areas and the rest of the nation.

Oil Search encourages the State to utilise this opportunity to examine how the benefits derived by Government from resource projects are most effectively and efficiently managed and distributed to the people of PNG. From its unique position as Operator of all of PNG’s oil and gas production, Oil Search has witnessed an increasing degradation in the integrity of benefits management and service delivery capability resulting in hundreds of millions of Kina being spent with little tangible result. In particular, we support the Government in its recent efforts to focus on how to meet the infrastructure delivery challenge and the achievement of the goals in the Strategic Focus Areas outlined in Vision 2050.

The Shared Responsibility Model (SRM) recently approved by the National Executive Council is an important initiative to address the missing link between revenue collection including its devolution to the Project Area Beneficiaries and successful delivery of social and economic infrastructure. The SRM, commencing from 2014, currently extends to the remainder of the Infrastructure Development Grant (IDG) of K1.2 billion and the High Impact Infrastructure Projects (HIIPs) of K460 million. Oil Search and the LNG Operator Exxon Mobil have committed resources to assist the State and the Provincial Governments in operationalising the SRM through Infrastructure Development Units in the Provinces and National Programme Management Unit at the Department of National Planning and Monitoring. Oil Search submits that the Government should adhere to the SRM and expand its scope to include Development Levy benefits.
PNG should give due consideration to the regional energy supply challenges and the opportunity presented by the Asia Pacific region’s energy needs. Continuity and certainty of the fiscal regime and appropriate levels of taxation are required to maintain the global competitiveness of PNG energy exports. The level of business and consumer confidence in the non-resources sector witnessed in PNG in recent years will also be best served by a continual flow of large scale resource projects.

The current oil and gas fiscal regimes are well balanced. Any material changes aimed at increasing the Government take or introducing new fiscal instruments will be unnecessary and likely destabilising. The focus should be on the consolidation of the existing fiscal regime, improvement in the area of tax administration, and ensuring the delivery of social infrastructure and benefits to the broader regional community.

With the successful financing and delivery of the PNG LNG Project ahead of schedule, PNG has positioned itself as a credible LNG exporter internationally and has experienced an unprecedented boost in the domestic economic activity. In our view, it is critical that PNG maintains the momentum. PNG’s development agenda is better served by increasing the tax base by supporting a series of new project developments rather than creating encumbrances to new projects through changes in the fiscal mechanisms.

Projects transition through a life cycle of exploration and appraisal through to development, which in the case of PNG LNG, took up to 20 years. A number of factors need to converge in order for projects to move through each stage in its life cycle. The fiscal regime is a significant factor in capital allocation by investors in a globally competitive environment. It can adversely affect investment in exploration and appraisal activities if developers do not see a path through to economic development.

**Specific Proposals in the Issues Paper**

1. Oil Search welcomes the forward looking approach in the Issues Paper, especially that any changes will only apply to new projects. Any changes to the fiscal regime should not apply to any projects or licences for which there already exists a petroleum agreement or gas agreement.

2. The Issues Paper explores the possibility of introducing a new fiscal instrument (sliding royalty, R-Factor, tax surcharge) in the place of the existing progressive regime that includes State Equity (22.5%) and the Additional Profits Tax (APT) as a means of capturing resource rent. APT, unlike other measures, is a post-tax IRR-based measure and takes into account all variables including the time value of money and is, in our opinion, a conceptually sound and appropriate instrument.

3. State participation is important for PNG for reasons beyond the pure fiscal returns. It is an important avenue to address the ownership aspirations of the nation and its people without having to undertake exploration risk. In the past, apart from providing a constant stream of cash flows, the State participation has enabled significant wealth creation for the State and the landowners in the form of a disposable asset and material capital appreciation. The alignment of interests of all stakeholders that the State provides through equity has been a significant comfort factor for the financiers, buyers and the company board rooms. A new, pure fiscal instrument of resource rent tax such as sliding scale royalty or R- Factor or tax surcharge contemplated in the Issues Paper is not a perfect or preferred substitute for State...
Section 2: Executive Summary

4. APT is a conceptually sound instrument available to the State to achieve desired progressivity in State take, as it is based on post tax rate of return which incorporates all variables including the time value of money. We acknowledge that APT has not triggered in the past, which is a function of initial capital expenditure, project returns and APT thresholds. The thresholds and rates are negotiated by the State in a Gas Agreement. The State can make this instrument very effective by appropriately analysing the growth scenarios in the project-specific economic models and targeting reasonable levels of thresholds and rates. Apart from there being no need for the introduction of a new fiscal instrument, the proposed instruments ignore the time value of money and have the potential to bring in resource rent taxation even at negative project Net Present Value (NPV). The Issues Paper clearly mentions that the objective of any resource rent tax is to apply to “economic profits” i.e. super profits rather than “normal profits”, where the term “normal profits” refers to allowing the firms to achieve Internal Rate of Return (IRR) equal to the hurdle rate or in other words be NPV-positive. The proposed measures of resource rent tax do not meet this policy objective and will seriously impact project decisions.

5. We recognise that the mining sector has a different fiscal regime from the oil and gas sector. We do not consider it appropriate or necessary for both sectors to have the same or similar fiscal regimes as they are, by their nature and characteristics, different industries with different exploration costs, project life cycles, investment profiles, risk profiles and market dynamics. For instance, unlike mining, an onshore oil and gas well costs over US$100 million and gas commercialisation requires long term (30+ years) contracts.

6. We urge the Committee not to introduce an additional 10% dividend withholding tax on oil and gas projects, either as a means to seek uniformity with mining, or as a measure to capture resource rent. The gas sector already has APT to capture resource rent. In the oil sector, the differential between the 45% new oil project tax rate and the general company tax rate of 30% already represents resource rent tax capture. As most future developments in our sector will likely come in the form of gas projects rather than oil projects, the proposal to lower the oil tax rate to the same level as gas and levying a 10% dividend withholding tax is basically an additional tax on gas projects, which in our view is not consistent with the aim of maintaining momentum in the LNG industry.

7. Oil Search welcomes the proposal to widen the tax ring fence by removing the 10% of tax payable limit for amortisation of the exploration pool. It will bolster exploration activity in PNG and help PNG realise a sustained accretion of new hydrocarbon reserves. In our experience, this change would bring PNG in line with many other resource rich countries. Oil Search considers this to be a more balanced instrument in promoting exploration as against tax holidays, double deductions or accelerated depreciation.

8. The proposal to remove the 2% free equity for landowners and replace this with an option to acquire a 20% equity stake on commercial terms is unlikely to work in practice. Oil Search considers landowners to be important stakeholders and partners and the 2% free equity should continue. In our experience, free equity has benefited the landowners more than commercial equity due to the value surplus between present value of net cash flows and the acquisition price.
9. Oil Search does not support the 2% fiscal stability premium and the resultant increase in the tax rate to 32%. As fiscal stability is required for any financing package for a large scale resource project, this is effectively a financing charge which is inconsistent with supporting ongoing growth in the LNG industry.

10. The proposed change in the basis of calculation of royalty from well head value to “gate price” is essentially an increase in the rate of royalty which would weaken project economics.

11. The tax credit scheme has proved to be an effective mechanism for the delivery of required social and economic infrastructure such as roads, schools and hospitals and an effective avenue to promote local business development. The scheme should be expanded, not contracted. Passing a 55% burden to developers will put a complete stop to any new project and the challenges of institutional capacity and pressure of non-governance at the provincial level would mean that the project community will be deprived of much-needed infrastructure, facilities and services.

12. We encourage the Committee to expand the scope of its deliberations and examine the potential for the introduction of a tax grouping regime to incentivize continued investment in exploration in PNG.

This Submission contains detailed explanations of our views on these matters and on other tax and policy questions raised in the Issues Paper. We are keen to work with the Committee and the Secretariat in developing a common understanding of these issues and their consequential impacts.
Section 3: PNG’s Petroleum Sector

Overview
PNG has long been identified as an area for prospective petroleum development and the potential was realised in 1992 when PNG produced first oil from the Kutubu fields. In spite of a proliferation in the number of prospecting licences awarded, PNG has not readily been able to attract and retain sufficient world class oil and gas exploration companies to maximise the value creation from petroleum projects for the PNG economy. With a few exceptions, of which Oil Search is proud to be one, limited exploration drilling has taken place in recent years.

Oil Search believes that PNG remains largely unexplored. Most of the acreage in PNG which is spread over 5 sedimentary basins, remains largely unexplored (see map below)

![Figure 2 Sedimentary Basins of PNG](image)

Apart from the challenges of topography, upfront cost of infrastructure and high cost of drilling referred to below, the State needs to take into consideration the history of long gestation periods to project delivery. Commercialisation efforts on the PNG LNG Project, earlier known as the PNG Gas Project, commenced in 1997 with a final investment decision (FID) in Dec 2009 and first LNG in 2014. The field discoveries themselves preceded the commercialisation efforts by over 10 years, with major discoveries at Kutubu and Hides made in the nineteen eighties. The success of the PNG LNG Project, to some extent, is attributable to the solid policy framework provided by the Gas Policy White Paper of 1996, but to an even greater extent to the continuity and certainty of the fiscal and regulatory regime provided by the State notwithstanding changes in government and the negotiation of two gas agreements.

In spite of the success of the first gas development, there are a large number of gas fields discovered many years ago which are yet to be commercialised. Apart from the relatively reasonably sized
discoveries such as Elk/Antelope and P’nyang, there are many satellite gas fields such as Pandora, Stanley, Kimu, Uramu, Elevala and Barikewa which pose major policy and commercial challenges of aggregation and commercial viability. In addition to significant capital expended on exploration, the developers continue to spend hundreds of millions of dollars in appraisal and commercialisation efforts based on the existing fiscal regime and an expectation of its continuity. The certainty of fiscal and regulatory regime is beyond doubt the single biggest factor which will determine the pace and nature of future gas projects in the country. We believe the pace and nature of gas developments will have significant impact on the Exploration and Production landscape in the country and on the economic development aspirations of the country.

One of the key drivers restricting exploration drilling within PNG is the challenging nature of exploration in the country. PNG has a difficult topography and climate, a lack of infrastructure, no local industrial base, features customary ownership of land and is a clan-based society. This means that most exploration and development activities are supported by helicopters and require the construction of roads and bridges for access and the importation of most materials, machinery and skilled labour.

The project areas not only lack basic infrastructure but also any form of civil administration. Before any exploration or development work can commence, the developer has to expend funds on putting in place basic infrastructure, community affairs programmes, providing security in the area and providing basic community services.

To overcome these challenges, oil and gas companies must invest significant amounts of capital through all stages of the oil and gas life cycle. As a result, we believe it is misleading to assess PNG’s petroleum tax rates simply by comparison with other jurisdictions, as the operating environments in most other countries do not present commensurate challenges. For example, the costs of finding resources in PNG are best illustrated in the chart below. The chart represents independent global data from JS Herold, highlighting that the cost of Oil Search's activities in discovering oil and gas in PNG is the 179th highest from a pool of 199 companies globally. We believe that these costs are similar to other explorers in Papua New Guinea. Finding costs represent a convergence of the cost of exploration and prospectivity or probability of success. Not all exploration success results in development. Prevailing global conditions, commodity price outlook and development costs could preclude a reasonable discovery from proceeding beyond the exploration stage. There is no real difference in finding costs between onshore and offshore exploration activity. The scale of any discovery therefore needs to be material in order to proceed beyond the exploration stage.
To contrast the costs of exploration of different geographies within Oil Search’s portfolio, below is a comparison of the seismic costs for a number of PNG fields compared to the Taza field in Kurdistan.

Figure 4: PNG’s 2D Seismic Survey cost compared to Kurdistan.
Whilst exploration costs in PNG are high, the same analysis applies equally to development costs, where the same challenges exist. Equipment and people typically need to be transported by helicopter, large areas of land need to be cleared for plant and accommodation and pipelines need to be built through dense tropical rainforest.

Aspects of PNG’s high cost environment
- Drilling -

- Average well cost ~US$50m (mix of 27 development and exploration targets, 2008-2013)
- Recent high cost wells:
  - Trapia >US$130m
  - Cobra >US$90m
  - Mananda >US$70m
- Offshore wells >US$40m/well

The PNG environment produces higher relative drilling and development costs, effectively factoring in a ‘hurdle’ to consider before making positive investment decisions

Figure 5 High Drilling Costs in PNG

One of the other key cost challenges in developing projects in PNG is financing. The current PNG banking sector does not enjoy sufficient liquidity to support the financing of large scale resource projects. This results in a need to obtain financing from a suite of international banks and other financial institutions. The PNG Government does not possess the capacity to contribute to its share of costs. Typically, not only the debt portion (which is jointly project financed), but also the equity portion requires financing.

Typically, financiers lending into projects based in PNG will apply a country risk premium. Whilst these premiums vary according to various factors such as convertibility, perceived levels of Sovereign risk and other macroeconomic factors, the country risk premium for PNG is several hundred basis points (see table below for indicative risk premiums). This makes PNG a higher cost country in terms of financing any future project, which directly affects the rate of return that can be achieved. The political risk insurance cost in recently financing in PNG was set at 175 basis points.
Against the backdrop of a high cost operating environment, there are also supply side pressures that will affect future global LNG development. As can be seen from the table below which illustrates installed new LNG capacity, there is substantial new capacity coming on line, especially in the Asia-Pacific region, which could lead to increased pressure on pricing as new supply comes on-stream.

**Figure 6 Country Risk Premiums**

**Figure 7 Increasing trend in global LNG Supply**
Independent LNG data providers such as Wood Mackenzie present a future for the Asia Pacific LNG where the supply and demand balance switches to excess supply from around 2020 (see graphic below). LNG supply contracts required to underpin a final investment decision in 2015/16 will be competing at this point of potential over supply. The economic and fiscal competitiveness of new LNG projects will be more important than ever before.

Figure 8 LNG Demand and Supply Forecast to 2025
At a minimum, the potential oversupply or increased supply competition of LNG projects into the Asia Pacific market will result in downward pressure on LNG prices as presented by the Wood McKenzie research below:

Figure 9 Global Gas Price Outlook
With respect to the US, the advent of shale gas, the increased number of export licences being granted and the widening of the Panama Canal to allow use by LNG tankers are all significant drivers in providing a low cost supply of LNG to the Asian region.

This increased supply and potentially at low cost, means that the long term forecast Japanese Spot LNG price is waning, whilst the US Henry Hub price increases as the demand for US export gas increases.

This is a substantial threat to competing projects and this pressure has already caused significant concern within the Australian market where the LNG projects tend to sit at the upper end of the cost curve. The onshore processing of gas from the Browse gas field has been scrapped and the partners are looking at a floating LNG solution; the expansion of the Gorgon LNG project has been deferred as has the Arrow Energy coal-seam gas LNG project.

Hence, the key to success for any future LNG developments in PNG is that they are at the lower end of the cost curve, provide competitively priced LNG to end users and that they are able to generate returns for project developers that compensate for the substantial capital investment required for any LNG development. The chart below demonstrates that the PNG LNG project is expected to result in a capital unit cost outcome that is close to the average, relative to global LNG projects currently under development. However, it should be noted that substantial North American and East African competitors are expected to set price points that are more competitive than those achieved by the PNG LNG Project.

![Figure 10 Rising Capital Cost of LNG Plants](image)

While the above chart represents capital cost, the next most significant cost for an LNG project over its life is taxation and, together, these inputs will drive the return to the project developers. It is, in the opinion of Oil Search, critical that the PNG Government deploy the available taxation levers to ensure that the next LNG project in PNG is able to compete in the Asia-Pacific LNG market despite the inherent challenges in PNG and the cost advantages available to competitors.
Provided that the status quo is maintained, in our view, PNG is well positioned to meet future LNG demand. If however the regime is altered in a manner which is unfavourable to project developments, there is a risk that future LNG projects in PNG could be substantially or indefinitely deferred akin to their Australian counterparts.

Benefits to Project Area Stakeholders

Papua New Guinea’s petroleum industry has long been a significant contributor to PNG, having contributed over 13 billion Kina in taxes, landowner payments and corporate contributions over the life of the current projects. Therefore of significant importance to the industry is the optimal management of these benefits, as well as channelling them into development through an effective and efficient infrastructure delivery mechanism.

The State takes its share of the economic surplus from resource projects in the form of royalties, development levies, State equity and taxation including APT. As a matter of both public policy and prudence, the State distributes a substantial portion of this to the project area landowners, affected provincial governments and local level governments (“Project Area Stakeholders”). This has evolved over time both in format, elements and rates.

For the PNG LNG Project, the Project Area Stakeholders, under the Umbrella Benefits Sharing Agreement with the State, negotiated the following devolution of benefits:

a. K350 million as compensation for the unmet previous commitments  
b. K 120 million Business Development Grant  
c. K1.2 billion as Infrastructure Development Grant  
d. K460 million as High Impact Infrastructure Projects  
e. 2% royalty (equating to circa K 7 billion over project life)  
f. 2% development levy (equating to circa Kina 7 billion over project life)  
g. 7% of participating interest in the Project (2.8% free and 4.23% at commercial price) (equating to circa K19 billion over project life).
Based on current modelling assumptions, the total value of these benefits granted by the Government to Project Area Beneficiaries exceeds Kina 50 billion and represents approximately 25% of the State take from the PNG LNG Project. Forecasted annual cash flows to the Project Area Stakeholders range between 1.5 billion to 2 billion kina and are summarised in the graphics below:
Oil Search, as a long term contributor to the growth of PNG, is fully supportive of the benefits being provided to the Project Area Stakeholders. Furthermore, from the perspective of economic efficiency and taxation policy, we fully support these benefits being translated into the tangible economic improvement of the regions and Provinces impacted by the Project. We would support the Committee considering further specific recommendations in this regard and would welcome any opportunity to work with the Committee to further consider the devolution of benefits and management thereof as part of its terms of reference with respect to the efficiency of the taxation regime.

Oil Search encourages the State to utilise this opportunity to examine how the benefits derived by the State from resource projects are most effectively and efficiently managed, delivered and distributed to the people of Papua New Guinea. As previously mentioned, from its unique position as Operator of all of PNG’s oil and gas production, Oil Search has witnessed an increasing degradation in the integrity of benefits management and service delivery capability resulting in hundreds of millions of Kina being spent with little tangible result. In particular, we support the Government in its recent efforts to focus on how to meet the infrastructure delivery challenge and the achievement of the goals in the Strategic Focus Areas outlined in Vision 2050.

Oil Search has worked collaboratively with the Government and the LNG Operator in developing a Shared Responsibility Model (SRM) for benefits management and project delivery. The institutional framework and governance mechanism under the SRM allows Oil Search and ExxonMobil to work with the State and the provincial governments from project identification, endorsement, funds management to project management, delivery and reporting. The provinces identify the projects, the State through the Expenditure Implementation Committee (EIC) approves the projects, and the LNG Operator and the Oil Operator deliver these projects with the assistance of landowner companies. As part of institutional capacity building, five Infrastructure Development Units (IDUs) have been set up in each of the affected provinces and a National Programme Management Unit (NPMU) set up at the Department of National Planning and Monitoring to provide overall coordination. Both IDUs and NPMU are fully funded from the project budgets and are co-staffed by Oil Search and ExxonMobil alongside the provincial and State officials.

The SRM has been approved by the National Executive Council and endorsed by the EIC. Currently, the SRM covers the remainder of the Infrastructure Development Grants of K1.2 billion and the High Impact Infrastructure Projects of K460 million. Oil Search submits that the SRM is a significant step towards developing institutional capacity and governance framework for benefits management and project delivery. We urge that the Government adheres to the SRM framework and, in due course, expand its scope to include other benefits such as Development Levy. Oil Search suggests that the Committee provides suitable recommendations to the Government on criticality of the benefits management and as an important adjunct to the fiscal regime as they complement each other in furtherance of economic development aspirations of the nation.
Benefits to the State

Based on the current modelling assumptions, the State will receive significant direct cash flows from the PNG LNG Project ranging from Kina 3 billion to Kina 7 billion a year, totalling to K184.5 billion over the life of the project.

![PNG LNG Cashflows to PNG Government (Train 1&2)](chart)

*Figure 13 PNG LNG Project (Train 1 and 2) Cash-flows forecast for the Government*

NB: Based on grossed up OSH forecasts. May not be representative of tax position of other project partners
Section 4: PNG’s Petroleum Fiscal Regime

Overview: Government Take vs Company Take

The Tax Review Committee’s Issues Paper accurately summarises the existing fiscal regime as it applies to petroleum. The current fiscal regime has struck a balance between creating incentives for investment in resource projects whilst also ensuring that the State achieves an appropriate economic rent for the exploitation of its natural resources.

![PNG LNG Project - Government vs Company Take Percentage](image)

Figure 14 PNG LNG Project - Government vs Company Take Percentage

Figure 14 is based on the latest project model including pricing assumptions. The analysis reveals that in the context of the PNG LNG Project, the Government receives over 62% of the Project NPV, whereas the developers receive less than 38% of Project NPV. This is appropriate given the features that characterize PNG’s operating environment. Those features include high finding cost and gas commercialization challenges. The actual split would depend on various factors including global energy price environment.
International Comparisons
As it stands, PNG is already one of the highest taxing countries in the world when it comes to oil operations, outside of those countries which operate Production Sharing Contract regimes.

Figure 15 PNG’s ranking in State take as a % of Pre-Share NPV in Oil Projects
The analysis is also similar in the gas sector.

![Figure 16 PNG's ranking in Government Take as % of Pre-Share NPV (Gas Projects)](image)

The above tables illustrate that PNG is, by global standards, already realizing a substantial share of value from its petroleum projects. Any increase in State take could jeopardise future developments as the rate of return on comparable projects in other jurisdictions may exceed the return on PNG based projects.

From the Oil Search perspective, this is a crucial inflection point. If PNG tightens the fiscal regime applying to resources, it risks putting economic development in PNG on hold and creates a lack of competitiveness relative to global petroleum opportunities. By way of contrast, maintenance of the existing regime signals stability and provides project developers and financiers the confidence to continue to invest and undertake the substantial risks and capital commitments associated with petroleum investments.

Now that the larger gas fields have been developed, the policy challenge is to establish a supportive fiscal and regulatory regime to encourage the aggregation and development of smaller fields. PNG’s remaining geological prospectivity and the relative high cost environment are important elements in striking a balance between the appropriate level of State take from resource projects and encouraging sustained investment in the exploration and infrastructure that is required to promote development.

Oil Search submits that PNG’s solution to power shortages involves gas-based power generation and strengthening the total value chain from generation to transmission and distribution. Availability of adequate power and its affordability is an important ingredient to PNG’s aspirations to raise living
standards of its people and support economic development through industrial and agricultural development. Oil Search will work closely with the State and Provinces in developing viable and integrated solutions and collaborate in delivering them together. Oil Search supports making gas available for domestic power generation either voluntarily or through domestic market obligations. Apart from the established and future gas projects, smaller fields can play a key role in supplying gas for power generation either directly or through gas swaps. Oil Search is keen to work with the Government to develop a suitable policy and commercial framework for domestic gas availability.
Section 5: Exploration

Exploration Licenses and Competitive Bidding

There is potential for an improvement in the current licensing system in the PNG resources sector. Based on a study of the grants of petroleum licences from 2002 onwards, the average time from application to licence grant has been a little over 300 days, with some licences taking 3 years to grant.

![Figure 17 Range of time taken in licence grants in PNG (in days)](image)

We note that the Issues Paper considers the possibility of a cash bidding system. Oil Search does not support cash bidding. In our opinion, cash bidding does not maximise the benefits to the State in terms of realising exploration potential as the cash payments to the Government reduces the capital otherwise earmarked for exploration.

With respect to the competitive bidding based on work programme, before a bidding round begins, all potential bidders should be required to meet certain qualifying requirements, similar to those in other global oil and gas jurisdictions. These requirements could include:

- Does the entity have the financial capacity to undertake an exploration programme? What is its market capitalisation/net asset position?
- Does the entity have the technical proficiency to undertake an exploration programme?
- Proven track record or relevant experience in undertaking exploration activity in comparable environments (e.g. fold belt drilling)

In other jurisdictions, entities are ranked across these criteria and ascribed a rating. The rating of a particular entity determines the licence area(s) in respect of which a bid may be submitted. As a general rule, a higher rating denotes relatively superior experience and financial capacity. This mechanism prevents less substantial entities with little or no experience in the relevant operational environment from effectively buying their way onto a licence for areas where they simply do not have the capability to explore effectively or safely.
In order for PNG to create an acceptable bidding system, a significant planning exercise needs to be undertaken. This will include:

- Establishing a ratings system;
- Establishing a points system to measure bids;
- Establish the governance structure;
- Isolating which areas are going to be released via the bid process and in what order; and
- Creating a template bid pack that can be used.

In our view, establishing this system will require significant consultation with industry and may take a period of years to implement. Oil Search would welcome and support this approach.

Under the described system, the licences would go to those who were willing to mobilise the most resources in the shortest amount of time in conducting an exploration programme. This would lead to the maximisation of resource development in PNG. There is substantial effort required by Government, the Department of Petroleum and Energy (DPE) and industry to design and implement a work programme bidding system. Oil Search believes that the effort is worth the potential benefit for PNG and welcomes the opportunity to work with the DPE and Government on the details of such a system.

However, we maintain that a change of licencing system will not solve the fundamental problem of delay in the grant and renewal of licences and the awards being made to parties-

- lacking an established track record in the Exploration & Production sector
- with questionable technical capability
- possessing limited financial capacity

to the exclusion of the explorers with an established track record and a demonstrable long term commitment to Papua New Guinea. The focus needs to shift to restoring integrity, capacity, capability and governance of the regulatory institution\(^1\) that administers the Oil and Gas Act. This entails in part, a transformation of the Department of Petroleum and Energy which is an imperative. Any licensing regime, whether it is the status quo or otherwise, will not overcome the challenges that currently beset it unless it is administered by a regulatory authority employing a process that promotes confidence in the system. A renewed commitment to a joint industry-Government initiative to develop a Charter for the Petroleum Advisory Board is an example of initiatives that require revival.

**Deducting Exploration Expenditure**

Under the current law, a limit of the lower of 10% of a taxpayer's annual income or 25% of the undeducted exploration expenditure applies when a taxpayer deducts exploration expenditure against profits from operating licences. Whilst the ability to 'pierce' the tax ring fence to allow for this deduction is a positive feature, taxpayers undertaking large exploration programmes typically find that they have substantial balances of exploration expenditure that they cannot deduct against current year profits because they are capped out. The effective deferral of these exploration expenditures

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\(^1\) Department of Petroleum and Energy and the Office of the Minister responsible for petroleum and energy
deductions detracts from the economics of exploration. In the context of declining exploration in PNG, we strongly recommend removal of the caps or at least increasing the relevant percentages of each cap.

To the extent that full tax grouping was to be implemented then exploration expenditure should be fully deductible against other group profits and hence the annual cap would no longer be a relevant consideration.

In an examination of these provisions, we also recommend that the Committee considers amendments to Division 10 of the Income Tax Act. This amendment would permit exploration expenditure incurred by a taxpayer that is farming-in to a resource project (but is not on licence when the costs are incurred due to the exploration expenditure being a pre-condition for the acquisition of the interest in the licence) to be included in allowable exploration expenditure for the purposes of Section 155A of the Income Tax Act and hence may then be included in the Section 155N pool. As the law currently stands, it is unclear how this farm-in expenditure is treated. The correct result is that the taxpayer should be able to deduct the costs incurred, even in the circumstance where the taxpayer does not ultimately acquire an interest in the licence. Provided that the expenditure was incurred pursuant to a licence, this should meet the test of deductibility.

Responses to Tax Committee’s Questions

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<tbody>
<tr>
<td>Question 4.1 - do stakeholders consider that the current process of awarding exploration licenses in PNG is appropriate? Why or why not?</td>
<td>We believe that the current system could be significantly improved by a licencing system that seeks competitive bids from parties that have the financial and technical capacity to undertake exploration and development in an optimal timeframe.</td>
</tr>
<tr>
<td>Question 4.2 - in principle, should PNG consider moving towards a competitive tendering process based upon cash bidding? If so, should this process be applied to outstanding applications, with a moratorium introduced for the issuing of new applications until such a process is put in place?</td>
<td>A competitive bidding system based on technical and financial capability and based on work programme rather than cash would be the preferred outcome.</td>
</tr>
<tr>
<td>Question 4.3 - is the double deduction still required as an incentive to promote exploration, given the changes in PNG since it was first introduced?</td>
<td>Not applicable to Petroleum.</td>
</tr>
<tr>
<td>Question 4.4 - should the 10 percent annual taxable income cap limitation on deducting exploration expenditure be removed?</td>
<td>Yes, the 10% annual limitation should be removed to prevent the accumulation of non-deductible balances at the end of a project’s life.</td>
</tr>
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**Section 6: Aligning Income Taxes**

**Tax Grouping**

One of the major disincentives for taxpayers operating in PNG is the absence of tax grouping provisions or, alternatively, tax loss transfer provisions. At present, a taxpayer can conduct two or more mining or petroleum operations within a single legal entity, but due to the operation of the tax ‘ringfences’, cannot share tax profits and losses between the ‘ringfences’. This ability to share tax profits and losses between projects within an entity is commonplace in other resource rich countries including Australia, Russia, the US, Brazil and Canada.

Due to the size and scale of petroleum and mining operations, there is typically a very substantial upfront capital cost to put the necessary infrastructure in place. This creates a large pool of depreciation deductions that are available once the project begins to produce income. As a result, it can often be several years before the tax ‘ringfence’ becomes tax payable. Due to inflation and the time value of money, the value of those tax deductions diminishes every year and this affects the overall rate of return on a project. If these losses/deductions could be used at an earlier stage (i.e. by offsetting taxable income in other ‘ringfences’ owned by the same taxpayer group) this will increase the overall net rate of return across the portfolio of projects. In the current environment where capital is internationally mobile, the difference in the rate of return could mean the difference between projects moving into execution or being delayed because the return does not meet the internal hurdle rate or the rate of return is less than a similar project in another country.

The current tax ringfence approach also creates unnecessary complexity for taxpayers. Typically, petroleum companies will seek to own interests in a number of licences in a relatively small area. This allows the petroleum company to share infrastructure between the fields in the various licence areas. However, due to the complexity of the tax system, petroleum companies are then required to perform an arbitrary split of these expenses between the licences and in some cases, the fields within a licence. Given that one of the most significant objectives in the Issues Paper is administrative simplicity, tax grouping should be given strong consideration.

Tax grouping provisions will only be of benefit where an entity is undertaking multiple projects in PNG. It follows that grouping provisions do not assist a single project investment; rather it acts as an encouragement for international companies to continue to invest in PNG. Given the broader economic benefits associated with increased foreign investment (see PNG LNG for example), this should be a high priority policy for the PNG Government. The Government may be concerned about the potential initial financial impact on the National Budget as a result of introducing grouping rules, but given the forecast increased tax and dividend cashflows arising from the PNG LNG Project, this is the optimal time to introduce such measures to ensure the continued growth of the PNG resources industry beyond the current PNG LNG Project.

The reforms in this area can be structured in different ways:

1. **A tax consolidation system**
   This would be based on the Australian concept where all subsidiary entities of the head company are effectively treated as divisions of the head entity and so all the profits and losses within the group are consolidated.
2. A tax loss transfer system

Before this system can be implemented, legislative amendments need to be introduced permitting companies to create a tax loss out of their ACE and AEE deductions. Then tax ringfences within entities that are part of the same wholly owned group could simply transfer losses between one another to optimise the group’s tax position.

**Grouping for Petroleum Projects**

In the event that general corporate grouping provisions are not introduced, we submit that the Committee should consider the introduction of grouping provisions for Petroleum operations equivalent to those that have been introduced for gas projects.

In this context, it is noted that in the Government Statement on Natural Gas Policy of 1996 it specifically noted that PDLs should be grouped in relation to an LNG project as they would likely feed gas into one processing facility. The same is true of petroleum fields which also typically feed into a central processing facility and typically then feed into a single export terminal. The gas grouping provisions have been provided for in Section 158F, and it is recommended that these same provisions apply to petroleum operations where there is shared infrastructure. Again, this change would provide greater simplicity for taxpayers and the Internal Revenue Commission (IRC) alike.

**Harmonisation of Tax Rates**

The harmonisation of rates will likely have little practical effect as future developments in PNG are more likely to be gas fields as opposed to oil fields, based on current identified resources. Hence, the harmonisation of tax rates should not have a material effect on the future tax revenue of the State given that mining and gas are already subject to a 30% tax rate.

**Dividend Withholding Tax**

As it currently stands, distributions from petroleum and gas operations are not subject to a dividend withholding tax, but are subject to higher tax rate (petroleum) and a resource rent tax (APT for the PNG LNG Project). In any system whereby a revised resource rent tax is to be implemented (for petroleum and mining) or maintained (for gas), then the imposition of a dividend withholding tax is inappropriate. Effectively taxpayers would be subject to corporate tax at 30%, a resource rent tax at an as yet undefined rate and then would be subject to tax again on profits that have already been taxed twice. This would increase the overall effective tax rates on PNG resource projects to a very high level which is not sustainable given PNG is already a high-cost regime in which to undertake petroleum activities (as previously described). Introducing a broad dividend withholding tax regime will only harm PNG in the competition for foreign investment capital. As was highlighted in Section 3 above, PNG is already one of the highest taxing countries in the world when it comes to oil and gas operations, outside of those countries which operate Production Sharing Contract regimes.

We recommend that PNG adopt a system similar to the Australian dividend withholding tax system where dividends paid from previously taxed profits are not subject to withholding tax when paid to non-residents. We note that this is the same as the current approach in relation to dividends paid out of petroleum profits.

In the event that the Committee did recommend an expanded dividend withholding tax, we recommend that a clear exemption is maintained for dividends paid between members of the same wholly owned group of companies, provided that both members are PNG tax resident. Hence, it
would only be the final dividend paid by the ultimate parent company that would be subject to dividend withholding tax.

**Third Party Access Arrangements**

Oil Search supports the view raised by the Issues Paper that existing infrastructure should be fully utilised and where necessary expanded, rather than investment in duplicate infrastructure. We fully support this position as duplication erodes value from a Government perspective and makes new developments harder, more expensive and less profitable.

In keeping with the overriding theme of broadening Papua New Guinea’s tax base, there are a large number of satellite gas discoveries which need to be developed. Beyond the delivery of the Hides Gas to Electricity Project, the Kutubu oil project, the Gobe oil project, the Moran oil project, the PNG LNG Project and the Elk/Antelope discovery, the next chapter in gas development will be the aggregation of smaller fields. The policy focus needs to shift therefore to ensuring that access to infrastructure with the requisite capacity does not become an impediment to timely development. Whilst access to infrastructure is accommodated in the Oil and Gas Act and in the gas and petroleum agreements, these tend to get diluted on a project by project basis. We believe that PNG will benefit in further developing a policy and regulatory framework by promulgating:

- a reasonable rate of rate of return for infrastructure owners;
- infrastructure capacity requirements; and
- measures to encourage timely commercial alignment between the parties while of course protecting the rights of existing shippers.

**Transfers of Interests**

The current mismatch in the treatment of licence acquisition costs between mining and petroleum is clearly inappropriate. Whereas mining companies can deduct all of their acquisition costs (which presumably includes associated on-costs such as stamp duty), petroleum companies are only able to deduct the transferred Allowable Exploration Expenditure (“AEE”) and Allowable Capital Expenditure (“ACE”). Further, a buyer cannot require a seller to execute a transfer of these amounts, or the seller may have already deducted all amounts of AEE and ACE against its assessable income. Hence, it is not uncommon that the buyer actually acquires no tax deductions in respect of a licence acquisition.

Many countries either provide the acquirer an upfront deduction for the acquisition of a licence interest where the licence is still in the exploration phase (e.g. Australia) or a deduction over the expected life of the project to be carried on in the licence area. However, those same countries would typically tax the vendor on sale of the licence. In relation to the treatment of transfers there are broadly two approaches that could be adopted which would achieve symmetry:

1. Tax the vendor on sale, allow a full deduction for the acquisition price; or
2. Do not tax the vendor on sale, but limit the buyer’s deduction to the AEE.

If the Committee is considering a broader capital gains tax regime, Option 1 is clearly preferred as it provides for tax symmetry. That is, assessable on one side of the transaction and deductible on the other. If Option 1 was pursued in the absence of a broader capital gains tax regime, we recommend that the Committee introduce broad anti-avoidance rules to prevent taxpayers selling licences indirectly by selling holding companies which may or may not be resident in PNG. An appropriate
example is the Australian land-rich rules contained in Division 855 of the Income Tax Assessment Act 1997. Similarly, if PNG sought to tax those indirect disposals, then the buyer should still be entitled to claim a deduction for the value attributable to the underlying licence. The deductible value would need to be supported by appropriate evidence (e.g. a valuation opinion) where the licence was only a part of the underlying assets owned by the company purchased by the buyer.

If the Committee is not considering a broader capital gains tax regime, then deductions should be limited to the undeducted AEE of the vendor at the time of sale. In that event, we recommend that the law be amended so as make it mandatory for vendors to provide a notice setting out the amount of the undeducted AEE that the purchaser acquires.

**Rehabilitation**

The amendments to the treatment of rehabilitation expenditure effective from 1 January 2012 provide that taxpayers with more than one project can effectively transfer the tax loss incurred as part of their rehabilitation activities on one project to offset the taxable income on another operating project. These amendments were welcomed, but there is still a fundamental issue in that these provisions do not assist taxpayers who are only involved in a single project.

The proposed deductible contribution to a decommissioning/abandonment fund will assist in remedying this situation, but practically speaking, is unlikely to be attractive. The proposed mechanism effectively is a pre-payment of rehabilitation expenditure, and whilst a tax deduction is given, the return on the funds in escrow would be minimal. Most companies will be under pressure to return cash to shareholders in the prime earning years of a project as the shareholders will have been awaiting a return on their investment through the development lifecycle. Alternatively, most companies will consider that they can potentially obtain a higher return on the funds by committing them to a new project.

The Government’s policy position in 2000, following the Bogan Tax Review, was that new petroleum projects should be able to claim deductions for rehabilitation on a provisioning basis. We support this approach as it allows taxpayers to effectively deploy their operating cashflows during the operating years of a project whilst still providing single project taxpayers with a useable tax deduction for their rehabilitation costs.

If this approach was to be adopted, the Commission should strongly consider appropriate anti-avoidance rules so that taxpayers do not over-provide so as to reduce their income tax payments in the earlier years of the project. We would recommend that any deductible provision would have to be supported by an opinion from an appropriate qualified professional experienced in quantifying rehabilitation costs.

If the Commission was concerned about the impact on tax revenues of large initial provision for rehabilitation of new projects, the deduction for the provision could be spread over the expected operating life of the project.

**Gas to Oil Ratio**

Assuming that there is a harmonisation of the tax rates applying to gas and petroleum, this issue becomes irrelevant.
If the Committee was inclined to consider a potential change, we recommend the maintenance of the existing tests contained in the Income Tax Regulations. The nature of wet gas reservoirs and how hydrocarbons are optimally extracted and potential production downtimes may mean that a project could at times move between selling more gas or selling more oil. Basing the tax characterisation solely on what is sold could lead to anomalous results and hence the current test is considered the better option.

**Hedging Gains and Losses**

Hedging is undertaken to manage risk within an organisation and generally a taxpayer will expect that the hedge position should be offset against the physical position so that the overall net result is in line with their overall hedging strategy. For example, an oil company can enter a hedge so that they are guaranteed a certain oil price for the product they produce.

If hedging gains and losses were kept outside of the tax ‘ringfence’, then the symmetry that hedging is looking to achieve would be lost and taxpayers would pay tax on gains they would not otherwise have made. This is due to the fact that most operators do not have significant transactions occurring outside of their tax ‘ringfences’.

By way of example, a taxpayer with an oil ‘ringfence’ wants to guarantee that for its June quarter production that it gets $100 a barrel and hence enters into a cash settled derivative with a bank counterparty. If the sale price for the oil is below $100, then the taxpayer will receive payment from the bank. To the extent that the sale price for the oil exceeds $100, then the excess will be paid to the investment bank. If the proposal is adopted, then where the sale price is above $100, the hedge contract loss will sit outside the tax ‘ringfence’ that derived the sales income. The taxpayer will pay tax on the additional income over the $100 a barrel price, even though it has effectively paid this profit to the bank to settle the derivative. The loss on the derivative transaction is carried forward in the hope that it may be utilised going forward. That is, there is no symmetry of matching tax to actual profits. Hence, this proposal should be abandoned and hedging transactions should be available to offset the gain or loss on the physical transaction to which the hedge relates.

In the event that the proposal from the Commission is aimed at speculative trading that does not relate to an underlying physical transaction, then we would support these gains and losses being taxed in a separate ‘ringfence’.

If the concern of the Commission is asymmetrical related party swaps being used to move profits outside of the PNG tax net, then we would support any anti-avoidance provisions that the Commission would seek to introduce provided there was appropriate consultation on the form of these provisions. We would be keen to ensure that any such provisions would not prevent genuine hedging activities with foreign banks as they are the most utilised counterparty given the lack of liquidity in the PNG banking industry.

**Partial Year Depreciation**

As part of the harmonisation of the tax regimes between Mining and Petroleum, we would support a consistent approach to depreciation. The pro-rating of depreciation in the first year of a project earning assessable income is an established global practice and we would be supportive of that approach being applied.
Capitalisation of Interest in Development Costs
Quarantining and capitalisation of interest expenses incurred in connection with the construction of acquisition a capital asset for tax purposes is unique to PNG. In Australia for example, the test in relation to the deductibility of an expense is whether the amount is on revenue account and immediately deductible or is on capital account and hence should be capitalised and depreciated. Interest would rarely if ever be seen to be capital in nature as the question would be whether the borrowed funds were used by the taxpayer for the purposes of deriving assessable income, not whether the funds were borrowed in connection with construction or acquisition of an asset that will be used to generate assessable income. We recommend that Section 68(5) of the Income Tax Act be amended to specifically exclude interest expense.

Treatment of Corporate and Business Development Costs
Business development and other stewardship costs are effectively never deductible in PNG due to the single entity and tax ring-fence restrictions. Reinvesting profits and increasing the portfolio of business activities in PNG is an important aspect of contribution to growth of the country. The fiscal regime should be amended to support this principle.

Responses to Tax Committee’s Questions

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<tr>
<td><strong>Question 5.1</strong> - provided a suitable rent tax is introduced for mining projects (see Chapter 6), should new mining projects continue to be subject to a 30 percent income tax rate with a dividend withholding tax rate of 10 percent?</td>
<td>No. Firstly, mining and petroleum should be treated separately. We do not support the introduction of 10% dividend withholding tax for petroleum. The Oil tax rate of 50% and gas tax rate of 30% should be maintained. We recommend against the introduction of a new fiscal instrument to capture resource rent. APT and State equity already exist to capture resource rent.</td>
</tr>
<tr>
<td><strong>Question 5.2</strong> - provided a suitable rent tax is introduced for petroleum projects, should new petroleum projects be subject to a 30 percent income tax rate with a dividend withholding tax rate of 10 percent?</td>
<td>No, the existing rates of taxation for petroleum projects should continue to apply and no further resource rent tax should be applied.</td>
</tr>
<tr>
<td><strong>Question 5.3</strong> - what are stakeholders’ views on ensuring that there are third party access arrangements over the PNG LNG and any new gas project midstream and downstream infrastructure? What issues might arise in introducing such arrangements?</td>
<td>Provisions already exist in the Oil and Gas Act to allow third party access and hence no additional scheme is required. Generally, commercial parties invariably come to an agreement, based on the actual circumstances at the time, without directives from a regulator.</td>
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<tr>
<td><strong>Question 5.4</strong> - provided that a suitable rent tax and third party access arrangements over midstream and downstream infrastructure are in place, should new gas projects be subject to a 30 percent income tax rate with a dividend withholding tax rate of 10 percent?</td>
<td>No, the existing rates of taxation for gas projects should continue to apply and no new resource rent tax should be applied. APT provides a conceptually sound tool for the State to capture the upside/resource rent. Appropriate thresholds for the application of APT and the rates of APT negotiated at the time of the</td>
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forthcoming gas agreements will ensure that APT serves its intended purpose. No legislative prescription or change is needed.
No, there should be no dividend withholding tax for gas projects. Unlike mining, the gas sector has APT and the proposed imposition of dividend withholding tax is inappropriate.

<table>
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<tr>
<th>Question 5.5 – should the deduction of a buyer of a mining or petroleum interest be limited to the undeducted allowable capital expenditure and allowable exploration expenditure of the vendor?</th>
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<tr>
<td>In the absence of a capital gains tax regime taxing the seller of mining or petroleum interests, then yes, the deduction should be limited to the undeducted allowable capital expenditure and allowable exploration expenditure of the vendor.</td>
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<tr>
<th>Question 5.6 – in addition to the piercing of the ring fence, should taxpayers be allowed to make contributions to a mine closure trust to bring forward deductions for decommissioning expenses into the income producing phase of a ring fenced project?</th>
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<tr>
<td>Yes. However we recommend that the Committee consider going further and providing deductions on a provisioning basis to spread the deductions over the project life.</td>
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<th>Question 5.7 – should the application of the gas oil ratio test be measured on the basis of resource extracted to product marketed? What issues might arise with such an approach?</th>
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<tr>
<td>No. The existing Gas to Oil Ratio tests should be maintained. Any change would be largely redundant given most new projects will be designated gas projects from the outset.</td>
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<tr>
<th>Question 5.8 – should separable hedging gains and losses be taxed outside of the project ring fence, under the standard income tax regime?</th>
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<tr>
<td>No, hedging gains and losses should be taxed within the project tax ringfence.</td>
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<tr>
<th>Question 5.9 – should depreciation deductions be pro-rated in the first year of production?</th>
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<td>Yes.</td>
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<th>Question 5.10 – what other changes to Division 10 of the Income Tax Act 1959 could be made to align the income tax treatment of designated gas, petroleum and mining projects?</th>
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<tr>
<td>Taxation grouping or a system which provides for loss transfers between related parties should be introduced.</td>
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Section 7: Design of a Resource Rent Tax

Design of a Resource Rent Tax

Oil Search fully endorses the Committee’s view that a fiscal regime needs to be progressive and the State should be able to get a larger (not proportionate) share of economic surplus (i.e. project NPV) at higher levels of profitability. A progressive fiscal system, as the Committee has correctly argued, does not require the State to readjust fiscal measures if the oil/gas prices turn out to be far better than those assumed at the time of project sanction. Conversely, in a progressive fiscal regime, the developer should also not be required to seek amendments to the law from the State for relief if the pricing environment changes for the worse. In other words, a well-designed progressive fiscal regime adjusts both ways automatically. However, we disagree with the view expressed in the Issues Paper that a new fiscal instrument (such as an R-Factor, a sliding scale royalty or a tax surcharge) needs to be constructed or introduced to achieve progressivity/resource rent tax. As the Issues Paper acknowledged, the State participation of 22.5% and APT are two resource rent taxes already in place in the oil and gas sector. We submit that these are superior instruments for the implementation of resource rent tax to the proposed fiscal instruments.

New vs Existing Fiscal Instruments

As requested by the Issues Paper, we provide commentary on the proposed new fiscal instruments as a means of capturing resource rent. The key points are:

a. New instruments are not needed for the oil and gas sector as resource rent taxes already exist in the form of State equity and APT;

b. The new instruments are not superior to the existing ones in fiscal impact, simplicity and genuine progressivity;

c. The introduction of new fiscal instruments will have a disruptive effect which has the potential to add to the cycle time for new project moving towards Final Investment Decision and delay Government taxation revenues;

d. In the defence of existing instruments, they:
   - Have benefits for the State beyond collecting revenue;
   - Have worked with good effect in the past; and
   - Do not suffer from the “defects” the Issues Paper is concerned about.

The Oil and Gas sector has State equity and APT as a means of capturing resource rent (i.e. profits beyond normal profits as explained in detail by the Issues Paper). The 2% royalty, 2% development levy and 30% corporate tax are also applicable. The first two providing a share in revenue before profits arise or full cost recovery is made. The 30% tax rate acts to capture a share in the profits and again is payable prior to full project cost recovery as it is based on accounting/taxable profits, not cashflows.

State equity provides the State with exposure to the project upside in exactly the same manner as it does to the developer, but without the risk. The State acquires its participating interest:

(a) as an option not an obligation;
(b) at the time of the grant of a petroleum development licence (PDL) at which point all exploration risks have been borne by the developers; and
at past cost, which does not reflect the market value, and without interest which in present value terms is at a highly subsidised price.

APT will apply after a pre-defined IRR is achieved. The level at which an APT should apply may vary from project to project as different projects will have different project economics.

We analyse the proposed fiscal instruments below:

1. *Sliding scale royalty based on production or “profits”*. Even though based on “profits”, it ignores time value of money which is an important element in any economic analysis. It distorts decision making as well as the true nature of progressivity.

2. *R-Factor*. This also ignores the time value of money. Often R-factors and sliding scale royalty methods have been used internationally as a means of capturing the entire Government take (serving the purpose of both income tax and resource rent tax). In the PNG context, this will be in addition to the 30% income tax. R-factors apply even before “super-profits” arise and are not a “pure” resource rent instrument.

3. *Tax surcharge*. A tiered surcharge which also ignores time value of money.

To summarise, the key issue is that in each of these proposed measures the resource rent tax has the potential to apply before the hurdle rate is met (another way of defining normal profits) because they all ignore the time value of money, in contrast to APT and State equity. Any instrument which does not take into account the time value of money is inappropriate as project developers will be paying resource rent taxes before they have made a return in real economic terms. APT is a more robust instrument in effectively capturing resource rent than the alternatives suggested. APT is based on post-tax IRR which encompasses price movements, reserves upside, increased production, expansions, other revenues, cost savings and the time value of money.

Some of the proposed measures may have the merit of simplicity; however APT is not difficult to administer from a tax authority perspective and is similar to the post tax IRR based sharing regimes around the world. Although APT is more technical than the other alternatives proposed, a degree of sophistication in the design of a fiscal regime to achieve an equitable outcome is not a drawback, particularly when there are billions of dollars involved. The design of a resource rent tax should be based on an instrument that gives rise to the most equitable distribution of resource profits between the various stakeholders and ensures that there are adequate incentives for multiple development projects. This is particularly relevant for PNG at this time given that there is potential gas for future LNG trains but they must meet certain economic hurdles before sanction is possible.

The introduction of a new fiscal instrument will be disruptive for a number of reasons including lack of familiarity and uncertainty. It has the potential to add to the cycle time on proposed additional LNG trains as the developer will have to not only re-model the impact but will likely also have to take the project back through the internal investment approval process to confirm whether it is still worth commercialising. Each year added to the project cycle time reduces the return to the project developers and Government in NPV term. This is because it exposes new projects to an increased risk of changes in global prices and increased competition (losing its place in the queue) and carries with it the potential of missing the window of opportunity as other supply comes on board which meets existing global demand. The key question to determine is whether the new instruments are so superior to the existing mechanisms such that PNG should create this potential exposure? We would
argue not. Our economic modelling indicates that a year’s delay in project sanction for a large scale resource project, for instance, erodes hundreds of millions of NPV from PNG’s Government’s tax revenue. It can also create cyclical delays leading to a lower NPV and costly recycle of project developments. The preferred scenario is to maintain the status quo and reduce uncertainty for project developers.

State Equity
The State currently has a right but not obligation to take up to 22.5% participating interest in oil and gas projects at the time of granting of a PDL (i.e. at the time of project sanction). As outlined above, it has several fiscal attractions for the State including the fact that it is exploration risk free, full sharing of upside with the developers on equal basis, acquisition at cost or a discount in PV terms. State participation also needs be considered from a broader policy perspective. In a society based on customary ownership of land, there is a deep desire to own the resources. This desire manifests itself in various forms regularly in all sections of society. The State participation and devolution of equity to landowners and provincial governments provides an opportunity to own the project or co-own it. Replacement of State participation with a pure fiscal instrument, in our opinion, is unsustainable. Co-ownership provides for an alignment of interest between the parties which fosters a positive working relationship.

The landowners and provincial governments do not possess the financial resources to either pay for the past costs or new development costs alongside other joint venture participants. The current system provides them with an avenue to participate and own a portion of resource projects. Without State participation, the State will not be able to meet the continuing (and growing) expectations of these important stakeholders, leading to a potential Government backlash.

The Issues Paper suggests an alternative of providing this stakeholder group an option to purchase equity at commercial prices. As altruistic as this proposition may seem, unfortunately it is not practical. It is unrealistic to expect that they will be able to fund an acquisition on commercial terms. Banks will find it difficult to lend to these groups as they have no underlying assets to securitise. This in turn will put pressure on the State and the project developers to fund the acquisition of their interest as per current practice. This is not a cost that either the State or developers will be able to financially bear. Hence, the concept of this stakeholder group having a right to acquire a 20% equity stake will create expectations that cannot realistically be met.

Introducing a right to acquire a 20% interest would add significant risk to the project and reduce the risk-weighted NPV/IRR and make the financing of large scale resource projects harder and dearer. This may lead to a value dilution for both the developer and the State.

Turning to the existing State equity arrangements, the perception of a conflict in the role of the State as a regulator and as investor is not correct. The State does not become an investor until very late in the project life cycle and has no financial interest in the project up until the exercise of their option to buy-in. At the time and prior to grant of the PDL and all regulatory approvals, there is no investment by the State. The expectation of future equity return is no different to the expectation of tax revenue. Furthermore, the State equity is held in a separate company which, though owned by the State, is at arm’s length with the regulatory departments of the Government.
State participation also serves another useful purpose in the economic development landscape of the nation with an eye on the future. The State nominee has access to information and participates in the joint venture decision making in the same way as other joint venture partners. This provides highly valuable experience ranging from markets, commercial matters, project fundamentals and the operating issues which go beyond "training" of national manpower. It allows the State to build institutional capacity to support a national oil company in the future, similar to other nations in the developing world.

The recent successful financing of the State’s participation in the US$19b PNG LNG project underscores the point that financing is not a constraint in the State exercising its option to participate. On the contrary, over time the State participation becomes a significant asset. For instance, the State’s original equity in Kutubu and Gobe fetched a value of AUD1.68 billion when it sold the Oil Search shares to IPIC (the Oil Search shares were primarily the shares acquired in exchange for the State’s 51% interest in Orogen Minerals Ltd which held the State’s Kutubu and Gobe participating interests).

From the developer’s perspective, the State equity and its partial dilution to the stakeholder group serves an important function of project security and is viewed very favourably by project lenders.

Conclusion
In summary, we submit to the Committee that the State equity and APT should be retained in the petroleum sector and not be substituted by any of the suggested forms of new fiscal instruments. The State should continue to provide 2% free equity to landowners out of its 22.5% interest. We strongly advise against this being converted into a right to acquire a 20% equity interest on commercial terms.

The progressivity and potential application of a resource rent that may be achieved in the mining sector is a separate matter and should not affect the petroleum sector.
## Responses to Tax Committee’s Questions

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| **Question 6.1** - do stakeholders agree with the pros and cons of state equity participation as described? What other factors might be relevant when considering the benefits of State participation? | Equity participation in its current form should be kept. It:  
  - Captures upside for the State and Project Area Stakeholders.  
  - Provides ownership and of symbolic value in PNG.  
  - A cost free precursor to National Oil Company. It facilitates learning and capacity and capability building.  
  - Financiers view it positively as an alignment of economic interests with landowners and as a safeguard against potential disruptions. |
| **Question 6.2** - what are stakeholders’ views on the value of the State having a carried interest in a project? | Carried interest is not in accordance with current policy. The State is able to joint-finance its share of projects as we have seen in relation to the PNG LNG Project.  
Under the carry, the developer needs to raise money for the State’s share as well as the project cash-flows, which may make project financing difficult. |
| **Question 6.3** - as a general principle, do stakeholders agree that the State should focus on ensuring it collects a proportion of any resource rents in new projects through an appropriately framed fiscal instrument rather than through State participation? | No. State participation and APT are still the best means of collecting resource rent. Any experimentation with new instruments will have a disruptive effect and potentially delay new project decisions. |
| **Question 6.4** - what are stakeholders’ views on the various fiscal instruments discussed as a means of capturing resource rents? Which model might be most appropriate in PNG’s context and why? Should consideration be given to extending an amended Additional Profits Tax across the various sectors? | All of them have their drawbacks. The biggest weakness is that they ignore the time value of money and have the potential to apply in the normal profit range particularly as they will operate in conjunction with the 30% base tax rate. We consider APT to be the most appropriate instrument in the PNG context. |
| **Question 6.5** - should affected landowners be given the right, but not obligation, to acquire 20 percent of a project on commercial terms, to be exercised on or before the grant of the relevant development licence? | No. Equity participation on commercial terms will not work. The landowners cannot organise that level of finance. This proposal will create expectations that can’t be met and the State will ultimately have to provide the finance. |
Section 8: Royalty and Development Levy

Royalties
As the Consultation Paper correctly identifies, where development levies are payable, royalties are creditable against the income tax and they are effectively an issue of allocation of revenue between the National Government on one hand and landowners and Provincial and Local level Governments on the other. Where development levies are not payable, then royalties are merely deductible for income tax purposes and hence generate a real cost to a project.

Royalty and Development Levies are a real cost to a project and can lead to taxpayers making Government payments akin to a tax without actually deriving a profit. This is most common where new projects are in their ramp up phase and due to high depreciation and operating cost charges, they are actually deriving a tax loss.

Any potential increase in the amount of royalty payable, as a result of either increasing the rate or a de facto increase attributable to a change in the manner in which the royalty is calculated, is a direct cost to a project and therefore undermines the economics at a time when macroeconomic factors are making these projects more challenging. As highlighted previously in this submission, in our view, the reform agenda should be aimed at boosting the economic incentives to explore and operate resource projects in PNG. Hence, we recommend that the Committee maintain the current Royalty and Development Levy system which we consider fair and equitable.

If the Committee feels that the manner in which wellhead value is determined is unclear, we would be supportive of any changes that may clarify the calculation, provided that any change is based on the proposition that there would be no net cash cost increase to the resource companies paying the royalty.

Responses to Tax Committee’s Questions

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<tbody>
<tr>
<td>Question 7.1 - do stakeholders agree that royalty rates should be maintained, with a</td>
<td>The existing royalty regime should be maintained, but no new resource rent tax should be implemented.</td>
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<td>focus instead on developing an appropriately framed resource rent tax?</td>
<td></td>
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<tr>
<td>Question 7.2 - for new petroleum and gas licences, should a field gate value basis royalty determination be used instead of a wellhead one?</td>
<td>No, this is a de facto cost increase with no gain to the State as it passes through to landowners.</td>
</tr>
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Section 9: Tax Incentives

Tax Incentives for New Projects
In granting tax incentives historically, the PNG Government has typically provided for a reduction in the applicable rate of income tax. As a general rule of commerce, the ‘playing field’ should be ‘level’ for all participants, i.e. no single party is favoured over another. Hence, subject to our comments below in relation to marginal projects, we do not support tax incentives for new projects.

These comments should not be construed as opposing tax incentives for an industry where the Government is seeking to stimulate growth. For example, the double deduction for exploration that was granted to mining companies was provided to stimulate mining investment and as it was available to all mining companies, was an appropriate action. Oil Search supports tax incentives in those circumstances. It is against provision of tax incentives to a single taxpayer in an industry to the exclusion of their competitors.

In terms of the type of tax incentive that should be provided, we agree with the comments of the Committee in support of accelerated depreciation or investment tax credits as better tools to encourage growth than a simple deduction in headline tax rates. We also urge the Committee to consider tax incentives in the form of additional deductions for certain expenditure like the mining exploration double deduction and the previous Research and Development tax regime which was abolished on 1 January 2014.

Tax Incentives for Marginal Projects
In recent years, there have been numerous circumstances of resource discoveries that on the face of the reserves seem likely to be developed, but once project owners take into account the high cost of development in PNG and the lack of infrastructure to support project development, the extraction of the resource is found to be uneconomic or marginal without a material increase in commodity prices. Development of these ‘stranded’ projects would be an obvious benefit to PNG as a result of the jobs and associated economic activity that such projects would generate. However, project owners will only develop these assets if they see a likely return on their invested capital.

Where projects are marginal, the use of tax policy can assist in progressing these projects into development. However, Government needs to ensure that the allocation of any potential incentive is consistent and applied within strict guidelines. The availability of tax incentives is potentially subject to abuse where project owners could potentially use extremely conservative assumptions when submitting a case for an incentive to Government. To avoid such issues, any incentive which is granted should be linked to the profitability of the project, not a flat rate discount to the tax rate. At its simplest, this would be a tiered corporate tax rate which would increase in line with the profits generated by the project owners.

Infrastructure Tax Credit Scheme
The tax credit scheme was introduced in 1992 and to date over 423 projects across 12 provinces with a total spend of over K644 million have been undertaken. In recent times, many of the projects undertaken as part of the scheme have been completed in regional areas where National and Provincial Government programs have been unable to deliver improvements to infrastructure, security, schools and hospitals. Companies with large operations such as Oil Search have been able
to deliver these projects efficiently due to the relative proximity of their operational footprint, saving the National Government significant expenditure compared to comparable Government-managed projects.

Beyond the increased cost efficiency, these projects also contribute greatly to community relationships with large companies operating in their region and also foster a greater level of appreciation and recognition of Government due to their role in the approval process. Hence, the tax credit scheme is a significant success as highlighted by the Minister for National Planning and Development, in his presentation to the National Parliament of March 2013, The Socio-Economic Impact of the Tax Credit Scheme 1992-2012.

Currently, there is no incentive for foreign investors to participate in the tax credit scheme. Typically the operators of resource operations understand the benefits of participating in the scheme, but non-operator joint venture partners do not see any benefit and at times see participation in it as a financial cost due to the administrative time that participation requires but which is not always recoverable through approved projects. The proposed reduction in the tax credit from a full tax credit to a 150% deduction will likely eliminate a majority of the future expenditure on infrastructure projects under the scheme. This will raise the amount of cash income tax collected by the National Government, but likely at a significant social cost. Landholder groups will likely be opposed and it could promote disenchantment with Government in some areas which could harm production and development growth. Further, we submit that the National Government will not be able to deliver projects to remote areas with the same efficiency as existing field operators and hence in totality, there will be an effective economic loss if the Government is simply going to replicate the projects that taxpayers like Oil Search would have otherwise have delivered.

The theme that seems to be running through the comments contained in the Committee’s paper is that the Government does not have sufficient control over projects and does not get credit for the projects. The Government is in a position to control both of those issues, firstly through the Department of National Planning and Monitoring which must approve all projects and secondly by engaging with local stakeholders and educating them that these projects are effectively being built with Government funds. There is also some suggestion that the parties funding these projects get a goodwill benefit. This is no doubt true, but it is unlikely that joint venture partners will bear 55% of the cost of a new project (tax rate of 30% grossed up by 150% = 45% tax benefit) in return for a goodwill benefit, especially when they are not the operating party.

We submit that rather than seeking to limit the tax credit scheme, Government should seek to encourage greater participation by incentivising participation in the tax credit scheme. Through diligent control by Government as to what projects are approved, significant gains in national infrastructure can be made which will be of enormous benefit to the PNG economy and to the National Government in its initiative to drive PNG to become a prosperous middle-income economy by 2030². From the perspective of Oil Search, the PNG economy would be most advantaged by increased infrastructure spend in schools, hospitals, roads and ports. By increasing the skills and health of the population and providing PNG companies with more efficient means to distribute and

² Papua New Guinea Development Strategic Plan 2010-2030, Department of National Planning and Monitoring, March 2010
export their product, much of the underlying capacity in the PNG economy will be unlocked. This approach has already been effectively endorsed by Government by the establishment of the National Infrastructure Tax Credit Scheme which is targeting some significant potential future projects such as Samberigi-Erave Highway and the proposed Kikori–Tari-Koroba Highway.

We recommend that the tax credit scheme be amended in the following manner:

- That for each dollar spent on an approved project, the relevant party obtains a tax deduction of $1.10, i.e. a 10% additional deduction;
- The cap on the credit for mining, petroleum and gas operations should be lifted to 1.5% of the assessable income derived in a year, in line with the rates applicable to primary producers and tourism operators;
- The carry forward allowed under section 219C(3) should be expanded to 5 years;
- That credits can be allocated between members of the same wholly owned group and ringfences within those group members, regardless of which entity has the project approved.

Responses to Tax Committee’s Questions

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<tr>
<td>Question 8.1 - what are stakeholder’s views on the provision of tax incentives for the mining and petroleum sector? Should special reductions in main fiscal rates not be granted to any new mining or petroleum projects?</td>
<td>As a general proposition, we are only in favour of tax incentives for marginal projects.</td>
</tr>
<tr>
<td>Question 8.2 - should the infrastructure credit scheme be replaced with an infrastructure 150 percent deduction scheme, with an increase in the annual cap to two percent of assessable income?</td>
<td>No, this would significantly damage relations between operators, Government and the community and thereby undermine the State’s authority in remote areas as well as adversely affect a developer's social licence to operate. The scheme should be expanded and incentivized, not handicapped but adjusted only so that infrastructure is broadly in line with District and Provincial plans. The State, provincial and local-level governments lack delivery capacity and developers have a significant role to play. The proposed changes will significantly damage the tax credit scheme.</td>
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Section 10: International Aspects of the Mining and Petroleum Fiscal Regime

Thin Capitalisation

In most jurisdictions, thin capitalisation regimes are used by Governments to stop foreign investors leveraging their projects with related party debt at high interest costs so that they leave as little taxable income in the country of operation as possible. Oil Search supports the utilisation of thin capitalisation measures to limit this type of aggressive tax planning.

However, in the PNG context several factors need to be considered as part of an evaluation of the existing thin capitalisation rules as they apply to resource projects:

1. Resource projects are by their nature expensive endeavours and hence require substantial debt funding. There are very few resource companies large enough to fully fund resource projects from their cash balances, and due to the substantial difference between the cost of debt and the cost of capital, no resource company would ever solely fund a ‘greenfield’ project.
2. PNG’s banking sector has very limited depth and does not have the liquidity to fund large-scale projects such as the PNG LNG project. Hence, in order to arrive at a funding package, resource companies need access to foreign debt capital. Without it, no projects would be developed.
3. The current 3:1 debt to equity ratio was a Government led policy initiative that arose out of the Gas Policy White Paper from 1996.

We acknowledge that certain jurisdictions have tightened their thin capitalisation ratios in recent years, but some of those changes were in response to particular tax issues. For example, the changes in Australia were largely in response to taxpayers dumping debt in Australia as part of holding structure strategies that were possible due to the peculiar construction of Australia’s international tax laws. These issues do not arise in PNG as it is not tax efficient for foreign companies to hold their Asian regional structures through PNG for numerous tax and non-tax reasons.

It would appear that the proposed changes are seeking to prevent foreign investors over-loading their projects with related party debt to minimise their PNG tax liabilities. If that is the concern of the Committee, then the Committee should consider a reduction in the thin cap ratio to 2:1, but providing an arm’s length test is also introduced. If a major resource project can obtain senior debt from non-related parties at more than 2:1, they should be entitled to do so as it clearly signals a very strong and very profitable project for all investors, including the State.

In considering what ratio is representative of commercial gearing levels, the best example is the level of gearing on the PNG LNG project. That project is geared at 70%, well within the current thin capitalisation limit, but in excess of the proposed reduced limits. Large scale projects such as the PNG LNG can achieve this level of gearing as the projected cash flows are robust.

A reduction in the permissible debt equity ratio will also increase the burden on the State in funding its equity contribution to resource projects. Lower levels of project finance debt means a greater
equity contribution from all participants. This could be a significant issue from the State’s perspective given its historic difficulty in funding its share of costs for large scale projects.

Arguably the difference in the ratio that banks are willing to lend to is the justification for the existing differentiation in maximum gearing ratios between the resource and non-resource sector and hence if the Government is prioritising further investment in large scale resource projects, then the existing thin capitalisation limits should continue to apply.

Responses to Tax Committee’s Questions

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<tr>
<td>Question 9.1(a) - should PNG retain the thin capitalisation debt to equity limit applying to mining and petroleum projects when reductions are occurring in neighbouring jurisdictions?</td>
<td>Yes, the current 3:1 ratio should be maintained.</td>
</tr>
<tr>
<td>Question 9.1(b) - Would 2:1 or 1.5:1 be more representative of commercial gearing levels in PNG’s Mining, petroleum and gas sectors?</td>
<td>No, for large scale resource projects, a reduction to a 2:1 or 1.5:1 gearing level could be lower than the optimal mix.</td>
</tr>
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Section 11: Other Issues

Royalty Withholding Tax (RWT)
An increase in royalty is being proposed and with it, an increase in the percentage of RWT. Under Section 159(1) of the Oil and Gas Act, royalty is a benefits stream that belongs to the State and where it is paid, it operates as a tax credit for the tenement holder. At Section 168 of the Oil and Gas Act however, the State has granted that royalty to sub-national Government and landowners (if any exist) as a benefit. So then the State is providing a royalty benefit which it owns in any event and is then seeking to tax a greater percentage of the royalty benefit it has granted.

Oil Search encourages further thought is given to the policy rationale behind the existence of a RWT and the proposed increase in the RWT. Once that rationale is clear, we suggest exploring alternative means of achieving the same financial outcome for the State while retaining the cosmetic aspect of the royalty benefit to sub national Government and landowners.

Template Project Agreements
In relation to template project agreements, Oil Search is in favour of such agreements provided that flexibility is maintained to negotiate on the critical points regarding a new project. Having a template agreement in place should streamline the process by setting out all of the non-controversial clauses in language that will be well understood by all parties. The Government needs to ensure that it does not strictly adhere to the template when commercial issues require it to be altered in a manner suitable for all parties.

Given that the future in the petroleum industry is in new gas developments as opposed to oil, we suggest that the PNG LNG project agreement is an excellent starting point for the establishment of a template agreement.

Fiscal Stabilisation
Fiscal stabilisation is critical in developing nations so that both equity and debt investors in projects have certainty over controllable cash-flows. In any large scale resource project in PNG with a significant debt package (e.g. PNG LNG), senior lenders will likely require a fiscal stabilisation agreement to have been executed with the Government. Hence, it is important that the Government retains the ability to enter into such agreements.

As fiscal stabilisation is required to secure senior funding for a project, the imposition of any uplift above the baseline tax rate is effectively a Government imposed financing charge and is inappropriate for resource projects. The 2% uplift is a penalty on debt financed projects and has a material effect on the project economics and suggests that the Government needs to insure itself against future corporate tax rate increases. This is in contrast to the worldwide trend in relation to tax rates is for them to reduce to stimulate economic growth. This is evidenced by the reduction on the average corporate tax rate across the OECD countries which has fallen from 32% in 2000 to just 25% in 2012.
To impose a fiscal stabilisation charge in this environment reduces the attractiveness of PNG as an investment destination and hence the 2% tax rate uplift should be abolished. We note that this 2% uplift did not apply to the PNG LNG project and we believe that it sets the example that all future projects should apply.

**Most favoured taxpayer provisions**

In relation to a project, one of the critical elements that a project investor desires is tax certainty. Similarly, it is only fair that Governments should expect the same and that when a deal is agreed, parties should abide by those terms. Including most favoured taxpayer clauses in project agreements does create uncertainty for the Government and potentially also creates an uneven ‘playing field’ if some agreements enjoy such a clause and other projects have not negotiated such a clause. As with tax incentives, Oil Search is not in favour of granting such concessions on an *ad hoc* basis.

**GST**

The zero-rating of supplies made to resource companies effectively aligns with the zero-rating of sales of commodities by resource companies. Given the quantum of acquisitions by resource companies, the removal of zero-rating on supplies made to resource companies would create a very significant cash flow and working capital issue. Large projects could easily have tens if not more than a hundred million dollars of working capital tied up in GST refunds which would give rise to a significant additional funding cost. This is exacerbated by the inconsistent and ad hoc manner in which refunds of tax from the IRC are obtained. Oil Search would be troubled in having such a large portion of our working capital in the IRC’s hands. Given Oil Search’s strategy of reinvestment of profits into exploration and development, Oil Search generally runs a lean working capital balance. Relying on timely IRC refunds could put Oil Search’s short term liquidity at risk, which could have
catastrophic consequences for banking arrangements (due to breach of financial covenants) and as a result, our share price. As stated previously, large scale resource projects need certainty and relying on the IRC to provide timely refunds as part of managing your liquidity and financing strategy creates substantial additional risk. Any consideration of removing zero-rating can only be considered when the IRC has shown years of strong and timely performance in its administration of the tax system, most notably in the assessment and refund of taxes owed to taxpayers.

Whilst a deferred payment scheme is supported, it cannot be at the cost of removing zero-rating on supplies made to resource companies. Whilst we acknowledge the administrative difficulties that the IRC may be experiencing with recalcitrant suppliers, it is not appropriate to transfer the problem to the resource companies in a move that will potentially undermine financing structures.

**Import Duties**

We agree with the comments contained in the Committee issues paper in relation to this issue and support a more transparent process in relation to the application of Import duties. The concessional treatments provided to certain taxpayers or projects undermines the confidence that PNG is a level playing field for all market participants and these should be abandoned in favour of a more structured approached.

**Responses to Tax Committee’s Questions**

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<td><strong>Question 10.1</strong> - should the withholding rate on royalties paid by resource projects to landowners be increased to the prevailing lowest positive personal income tax rate?</td>
<td>No. Other measures to ensure tax collection should be employed first</td>
</tr>
<tr>
<td><strong>Question 10.2</strong> - should template project agreements that will form the basis of any new project agreements within the country be developed and published?</td>
<td>Yes, this would assist timely negotiation of future project agreements</td>
</tr>
<tr>
<td><strong>Question 10.3(a)</strong> provided a suitable rent tax is imposed on resource projects, should the Resource Contracts Fiscal Stabilisation Act 2000 not apply to new projects?</td>
<td>Fiscal Stabilisation is required as part of financing any large scale resource project and hence the relevant Act should continue to be applied as required</td>
</tr>
<tr>
<td><strong>Question 10.3(b)</strong> otherwise, should fiscal stability obtained in exchange for a two percent tax rate premium be made symmetrical, time limited and limited to key rates of tax and duty and explicitly listed capital allowances?</td>
<td>The Resource Contracts Fiscal Stabilisation Act 2000 should be amended to remove the 2% premium in line with the PNG LNG agreement</td>
</tr>
<tr>
<td><strong>Question 10.3(c)</strong> What are stakeholders’ views on offering ‘most favoured taxpayer provisions’ or indemnification/compensation provisions?</td>
<td>Like a direct tax incentives, we are opposed to any measure which is discretionary and arbitrary</td>
</tr>
<tr>
<td><strong>Question 10.4</strong> should a GST deferral scheme be introduced so that the payment of GST on imports is delayed until filing the next GST return, at which time there will be a credit available offsetting the potential GST on the imported equipment?</td>
<td>A GST deferral scheme should be introduced, but not at the cost of removing zero-rating on supplies to resource companies</td>
</tr>
<tr>
<td><strong>Question 10.5</strong> - should import duty exemptions or lower rates be given to specifically listed specialised equipment not available in the market, and with the requirement that the equipment be re-exported after use if there is any remaining economic life?</td>
<td>Yes, we agree with this proposal</td>
</tr>
</tbody>
</table>
Section 12: Tax Administration

Whilst the Committee has not sought comment on the administration of the tax system by the IRC as part of the Issues Paper, it would be remiss not to provide comment on some critical aspects of their administration.

At the outset we should state that we are encouraged by the recent developments at the IRC. The IRC has invested in their people and their systems (e.g. the new TIN system) and we have also seen some more business-friendly processes such as self-assessment on FCWT and electronic lodgements. We encourage the Government and the IRC leadership to continue this process. However, there are still areas of concern as highlighted below.

Consulting on Tax System Changes
As part of the introduction of the IRC’s new electronic lodgement systems, the IRC had advised that it no longer provides receipts for amounts of withholding tax remitted to it. Companies such as Oil Search regularly are required to withhold amounts of FCWT and remit it to the IRC. Oil Search then obtains receipts and provides them to our suppliers on their request so that they can obtain a tax credit in their home jurisdiction for the withholding tax imposed. In the absence of a receipt, a credit is unlikely to be available and hence some suppliers are seeking to be compensated for that lost credit. We are working with the IRC to arrive at a solution that addresses the problem, but the preferred outcome would have been consultation by the IRC with industry before introducing the change so that any issues could have been solved before launch.

We encourage the IRC to be open to consulting with industry on potential changes in tax administration (as opposed to tax policy) so that the changes can be effected with minimal business disruption.

Assessment of Tax Returns
We recommend that the law be amended so that a taxpayer is deemed to have self-assessed their tax position on the day they lodge their return and hence the period for review should begin from that lodgement date, not the date on which the IRC finally assesses the tax return. This amendment would provide greater certainty for taxpayers, particularly certain foreign taxpayers who must report uncertain tax positions as part of their filings in other jurisdictions.

Response to queries
At Oil Search, we pride ourselves on open engagement with the IRC. We undertake to regularly contact the IRC to discuss various issues and meet face to face as regularly as possible. As the largest taxpayer in PNG, we expect that the IRC would demonstrate genuine active interest in a collaborative approach. We would encourage the Committee to endorse a client focussed culture within the IRC so that we can work together toward mutually beneficial outcomes.

Amending legislation
In recent years, there has been a growing trend towards the Government announcing tax reform measures as part of the annual budget, but the legislation not being introduced into parliament until such time later. Often the announcement of law changes is devoid of detail and hence taxpayers are unsure as to how to treat certain items of income and expenditure. We suggest that the
Government seeks to ensure that any announcement is quickly followed by draft legislation so that taxpayers are well placed to deal with legislative changes.
Section 13: Broader Policy Issues

Oil Search notes that the Committee has a broader policy agenda as its Terms of Reference. We understand that the Committee is aiming to widen the tax base and set up a platform for broader economic growth. This Submission has, in preceding Sections, focussed on responding to the specific questions raised in the Issues Paper while at the same time providing policy context as necessary. Oil Search feels that the work of the Committee represents a unique opportunity to examine the broader policy issues some of which have direct consequences not only on the expansion of the tax base in the form of new projects, but also on the effectiveness of the transmission from revenue collection to social infrastructure and service delivery. These also involve issues of equity (equitable distribution), economic efficiency and governance or in other words “tax efficiency” which we believe is the focus of the Committee’s deliberations.

Oil Search continues to work closely with our Government as partners in development to deliver social infrastructure on an interim basis as our institutions assume the capacity and capability to fully embrace their role. The preceding sections of this Submission address the Shared Responsibility Model as an example of that collaborative approach to infrastructure and service delivery.

In this Section, we capture some of these broader policy issues under the following subheadings:

- Benefits Management
  - Quantum vs Management
  - Prudential supervision of landowner trusts
- Petroleum Licencing System vs Capacity and Governance
  - Policy framework for petroleum licencing regime
  - Institutional transformation of the Department of Petroleum and Energy
- Efficiency and equity in the allocation of State revenue from mineral wealth
- New policy-setting for marginal field developments

Benefits Management

As mentioned earlier in this Submission, about K13 billion in direct cash has accrued to the Independent State of Papua New Guinea through existing oil projects in various forms: taxation, development levy, royalty, equity cash flows and landowner benefits. Of this, approximately K2.5 billion has gone to landowners, provincial and local level governments of project-affected provinces under various development agreements (Memoranda of Understanding or MOUs and in the case of Moran, a Development Agreement) between the State and the beneficiaries in the form of royalty, development levy, special support grants, business development grants, MOU payments, other contributions and ad hoc Ministerial commitments. However, this has not translated into visible signs of development that reflect the scale of the commitment in Kina terms. Much infrastructure or economic development and the projects committed under the MOUs and Moran DA still remain on the books as outstanding commitments.
So the proposition therefore is that the fiscal regime has delivered in Kina terms over the years and that at the heart of this debate is not State take, it is our ability to translate those benefits into basic infrastructure, services and economic development in project impact areas and across our country.

Andrew Anton Mako is a Research Fellow at PNG’s National Research Institute and a Research Associate of the Development Policy Centre. He wrote:

The once bustling government outpost of Kolombi, and the entire Paiela-Hewa LLG of 10,000 plus people is in dire need of basic services such as health, education, law and order, transportation, and agriculture extension services to this day. The airstrip has not been re-opened since it was shut down in 1996. After the airstrip closed down, a road was built to reconnect Kolombi to Porgera, but shrubs are now growing on the road due to lack of maintenance, despite numerous promises by local development authorities and MPs (both regional and local) over the last decade. The people of Kolombi and Paiela-Hewa LLG are struggling each day, despite the fact that the giant mining operation in nearby Porgera has been pumping millions of Kina into the coffers of the Porgera Development Authority, as well as other financial and spin-off benefits to the district since the early-1990s. These funds are meant for socio-economic development activities in Porgera and Paiela-Hewa LLGs. (According to this NRI report, that money disappears with little accountability and developmental trace.

At Christmas in 2007, I walked back to Kolombi from Porgera (as the new road and the airstrip were still closed) to visit my birth family and relatives. It was really sad to see the once-bustling Kolombi decaying. All basic government services remain closed, and people rely largely on traditional farming to survive. With no economic activities, such as cash-cropping and retail to support the local economy, Fridays are no longer the big market day. Those who are very sick but able to make the 12 hour journey must walk to Porgera to seek medical treatment. Children from Kolombi and the entire LLG continue to miss out on an education, except for those who are determined to go to Porgera to look for a school, as I did in 1997. My biological family, except for my mum, moved to Porgera when my biological father was transferred to an aid post in Porgera in the mid-2000s.

From stories I heard from my biological mum when we were both in Porgera last Christmas, Kolombi is still closed to the outside world. After nearly 20 years, all my childhood village friends whom I went to school with are just hanging out in the village. Life there is a struggle without opportunities, access to basic services, jobs or income.

In the late-1990s, the PNG budget was collapsing. But over the last decade, PNG has enjoyed a massive increase in revenue and a resultant three-fold increase in government spending. Despite this, many rural areas, including Kolombi and Paiela-Hewa LLG, have been neglected and remain closed to the outside world, just as when I left in 1997 as a teenager.

Personally, if I hadn’t made that decision to walk the treacherous 12 hour journey to the nearest town in search of an education and leave everything behind, I would be in the village now like my childhood peers, unemployed and scraping to get by. I am truly blessed and privileged, and thanks to many wonderful people, I have made it this far in life. But my heart goes out to the people of Kolombi and Paiela-Hewa LLG, and many other rural villages and towns in PNG which have experienced rural decay over the last 20 years.

We can and must do better. If we could organise basic services to rural villages like mine 20 years ago, why can’t we today when the government is so much better resourced?

A summary of the analysis carried out in the context of outstanding MOU/Moran DA commitments is given below. Figure 19 summarizes the infrastructure commitments contained in agreements between the State, Provincial Government, Local level Government and impacted landowners that are commonly referred to as the Kutubu Oil MOA.

**Kutubu MOA Analysis**

**Agreements**
- PDL Area Agreements
  - 1990 MOA with SHPG
  - 1990 MOA with PDL Los
  - 1996 MOA Review with SHPG
  - 1996 MOA Review with PDL Los

**Project Commitments**
- PDL Area Commitments
  - 55 Projects (common in all 4)
  - 2 Major roads
  - 1 Bridge
  - 14 schools/upgrades
  - 25 Health centres/Aid Posts
  - 7 Feeder Roads
  - 5 Telecom/Post/Water/Power
  - 1 Others
  - 50:50 (State: PG)

- Pipeline Area Agreement (s)
  - 1990 MOA with GPG
  - 1990 MOA with PL Los
  - 1996 MOA Review with GPG
  - 1996 MOA Review with PL Los
  - 2008 Review Agreement supersedes all

- 2002 Additional Agreement
  - 2002 additional commitments with Irakorahi PL Los

**Delivery/Disbursement**
- Project/Kina
  - 28 Projects Completed
  - K 93m out of K 114m (73%)
  - Additional K58m to K75m given as project moneys – none of above projects delivered
  - Additional K 167m given as SSG (for Projects) – none of above projects delivered
  - Remaining 27 Projects- Review – see next slide

**2002 Irakorahi Commitments**
- PL2 Access Road Upgrade:
  - Km55 to Kantobo
  - Km63 to Surawalo
  - Maintenance of 3 classrooms at Kantobo
  - New classroom at Kafa
  - Aid Post upgrade - Kantobo & Kafa
  - Airstrip upgrade - Kantobo & Kafa
  - All from tax credit

Figure 19 Summary of Kutubu MOA Commitments
Figure 20 Summary of Outstanding Kutubu MOA Commitments and funding sources

Figure 20 demonstrates how much more it will take to close out all commitments. Those commitments are identified in the list below at Figure 21.

**Kutubu MOA Listing**

<table>
<thead>
<tr>
<th>Completed</th>
<th>Not complete</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Pimaga Health Centre Upgrade</td>
</tr>
<tr>
<td>2</td>
<td>Mendi Hospital Upgrade</td>
</tr>
<tr>
<td>3</td>
<td>Declaration of Mendi-Poroma-Moro road as a national road</td>
</tr>
<tr>
<td>4</td>
<td>Construction of sub health centres at Yomasi, Kaipu, Kantobo, Gesge, Waro</td>
</tr>
<tr>
<td>5</td>
<td>Rural Police Husing Sisibia, Tage, Uriria, Waro, Kantobo</td>
</tr>
<tr>
<td>6</td>
<td>Pimaga Electricity Supply</td>
</tr>
<tr>
<td>7</td>
<td>Aid Post Yalanda</td>
</tr>
<tr>
<td>8</td>
<td>Aid Post Tugiri</td>
</tr>
<tr>
<td>9</td>
<td>Aid Post Hedinia</td>
</tr>
<tr>
<td>10</td>
<td>Aid Post Kafa</td>
</tr>
<tr>
<td>11</td>
<td>Aid Post Inu</td>
</tr>
<tr>
<td>12</td>
<td>Aid Post Sisibia</td>
</tr>
<tr>
<td>13</td>
<td>Aid Post Fogomaiyu</td>
</tr>
<tr>
<td>14</td>
<td>Community School Upgrade Tanuga</td>
</tr>
<tr>
<td>15</td>
<td>Community School Upgrade Waro</td>
</tr>
</tbody>
</table>
The key points in this analysis are:

1. Out of the 55 projects envisaged, only 28 have been completed (all of which were completed under the tax credit scheme) in the PDL area and no projects completed in the pipeline area or under the later MOUs;
2. A sum of K114 million was envisaged to complete these projects against which over K376 million was given directly for the projects;
3. The estimated cost to complete the remaining projects is now around K325 million; and
4. There is no coordinated approach between the delivery of social infrastructure on hand (e.g. hospital and schools) and the social services on another (e.g. medical staff housing, teachers' housing).
5. The Tax Credit Scheme has demonstrated its utility in delivering infrastructure where the Government is unable to do so. It is a partnership model that benefits Government, developer and the host communities.

The story is the same in Gobe and Moran as illustrated in the Figures 22 and 23 below:
# Gobe MOA Analysis

<table>
<thead>
<tr>
<th>Agreements</th>
<th>Project Commitments</th>
<th>Delivery/Disbursement</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>PDL Area Agreements</strong></td>
<td><strong>State Commitments</strong></td>
<td><strong>State Project/Kina</strong></td>
</tr>
<tr>
<td>• 1996 MOU</td>
<td>• 1 Project</td>
<td>• Total cost estimate unknown</td>
</tr>
<tr>
<td>• 1998 Revised MOA</td>
<td>• Road project estimated at K120m</td>
<td>• K 5m paid out</td>
</tr>
<tr>
<td><strong>State</strong></td>
<td><strong>Other Projects</strong></td>
<td><strong>Other Project/Kina</strong></td>
</tr>
<tr>
<td></td>
<td>• 12 Projects</td>
<td>• Total cost estimate unknown</td>
</tr>
<tr>
<td></td>
<td>• Paid for by the state but status unknown</td>
<td>• K 5m paid out – project status unknown.</td>
</tr>
<tr>
<td></td>
<td>• 3 Health centres/aid Posts/etc</td>
<td>• 1 project (Petroleum Training School) estimated at K 2m not started yet.</td>
</tr>
<tr>
<td></td>
<td>• 3 Schools/educational facilities</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• 2 Service infrastructure</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• 3 water supply</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• BD Seed capital</td>
<td></td>
</tr>
</tbody>
</table>

*Figure 22 Gobe MOA Analysis*
The policy question is whether the issue for Papua New Guinea is one of quantum or one of benefits management or a combination of the two? Increasing the benefits flow without addressing how these benefits are managed and without strengthening the institutional and project delivery capacity at the provincial and district level, has not and will not deliver economic development outcomes.

Against this backdrop, the tax credit scheme has been singularly effective in delivery project outcomes. To the end of 2013, the Government approved US$109.06 million in tax credit projects. All of these projects were successfully commissioned by ChevronTexaco in early years and by Oil Search since it assumed operatorship in 2003. The projects range from road infrastructure to projects in the health, education, law and justice sectors.

**Governance of Landowner Trusts**

The equity and royalty benefits bestowed by the State to project area landowners are held by corporate trustees and managed for the benefit of landowner beneficiaries. Under the Oil and Gas Act, 30% of these benefits are held in a future generation trust and another 30% in community investment trust with the balance of 40% being available for distribution in cash to beneficiaries. Over time, these two funds have accumulated significant amounts (a few billion Kina). These are funds held in trust for landowner beneficiaries similar to a superannuation fund, but unlike the latter, the operations of these trusts are not subject to prudential supervision.

Oil Search urges that the Committee considers prudential supervision of landowner trusts as an area of reform which ultimately would lead to the desired outcomes for economic development of the project impact areas as well as a source of capital to promote the growth of Papua New Guinea’s capital markets.
Petroleum Licencing | Cycle Time and Broader Governance Issues

Oil Search supports the Committee view that the regulatory regime and the efficacy of the licencing system are important adjuncts to the fiscal regime. There are significant issues in the way the entire process is managed involving large delay and awards to applicants with no technical or financial capacity or exploration track record. The graphs in Section 5 and below illustrate the time taken in grant of licence.

However, a change in the licencing regime from open licencing to competitive bidding (cash bidding or work programme bidding) will not address the issue. If the State expects improvements in the administration and strengthening in policy then this will not come without radical overhaul in the way the State regulates and its relationship with its regulatory agency.

Oil Search recommends that the degradation in the integrity of the regulation of the industry warrants an examination by the State of its industry regulatory philosophy (self-regulation, prescriptive, hybrid), the powers and responsibilities vested in the Minister responsible for the Oil and Gas Act, the relationship of that office with its regulatory authority and the workings of the regulatory authority as part of the review of the licensing system.

Figure 24 Licence Grants Cycle Time Analysis
Institutional Strengthening | Transformation of the Department of Petroleum and Energy (DPE)

Oil Search submits that the effectiveness of any policy, fiscal regime or regulatory regime, is only as effective as the institutions tasked with administering it. Over the years, the DPE, the regulatory body, has experienced significant challenges in terms of office space, finances, attrition, capacity, professional capability, and governance. The challenges faced by that institution over the years is a significant factor in the shortcomings of the current licensing regime. Admittedly, some of these issues are not unique to DPE, but the complexity of the business and materiality of the industry to our economy makes a compelling case for an urgent transformation. These constraints manifest themselves not only in terms of delays, but also during negotiation of gas agreements with the developer as well as development agreements with landowners and sub national Government and in addressing ongoing policy and commercial issues where the State is not able to get the support it needs in the analysis of positions, stakes and deal outcomes. In most cases, it is not the fiscal regime or the regulatory provisions that lack in offering opportunities to capture value for the State, but how these are negotiated, coordinated and administered by the relevant authorities.

We urge the Committee to offer recommendations on this matter as a matter of priority.

Since 2010, Oil Search has dedicated resources in-country PNG to work closely with the DPE to promote the transformation of that agency. The objective of the programme is for the institutional transformation to coincide with the delivery of a new office complex for the transformed regulatory authority employing the National Infrastructure Tax Credit Scheme. Oil Search is fully committed to continuing to promote that transformation agenda as a priority.

Efficiency and equity in allocation of resource revenue

Apart from the benefits granted under the oil MOUs and Moran DA, the State has granted significant benefits under the PNG LNG Project to the project area landowners, LLGs and Provincial Governments in the form of royalty, development levy, project equity and infrastructure development grants. The value of these benefits over the life of the PNG LNG Project ranges from K45 billion to K60 billion. In percentage terms, these exceed 20% of the total benefits accruing to the State from the PNG LNG Project, which is a limit prescribed under the Organic Law and later adopted by the Oil and Gas Act.

PNG has had particular difficulty in dealing with the issue of decentralization and Provincial and Local level Government as a consequence has never developed the capacity and capability to deliver services and build and maintain social infrastructure in the Districts and Provinces. It is against this backdrop that Special Support Grants and now Development Levy from the oil industry have been directed to the Provincial Governments and LLGs. However, the significant cash flowing from the oil industry to these Project Area Beneficiaries has not translated into development outcomes in the impacted Districts and Provinces. This perpetuates the perception that the fiscal regime heavily favours the extractive industry. Introducing FOB value to calculate royalty has the net effect of increasing royalties and potentially development levy. A financial windfall will be realised by

Depending upon future oil prices and exchange rates
Provinces that are already unable to handle current revenues from the oil industry. Institutional reform of Government at the sub national level to restore capacity and capability is the priority.

Beyond the focus on the project impact area, attention is also required at the national level. The work of the National Economic and Fiscal Commission\(^5\) warrants consideration as we enter the 2015 National Budget cycle.

The NEFC is an independent Constitutional advisory body of the State. It was established under the Organic Law on Provincial Governments and Local Level Governments (OLGPLLG).

Its main roles are to provide the Government with advice regarding:

- OLGPLL grants and other transfers from the National Government to Provincial and Local Level Governments
- the level of funding that is available to Provincial and Local Level Governments
- how equitably total funding is split between the various Provinces and Local Level Governments
- economic, planning and financial management matters that impact on the system of financial transfer between the levels of government

The role of the NEFC encompasses the following:

- assessing revenues available in the provinces and determining the level of operational (goods and services) grants in the re-current budget to the provinces and local-level governments
- monitor and review the operational (goods and services) grants on how provinces spend this funding
- conduct a periodic cost of services study to estimate the cost government’s basic service delivery obligations for grant calculation, policy development and budget purposes.

The proposition is that right across our country, if constituents are being educated about the enormous benefits brought about by PNG LNG and other resource developments but they do not experience the impact it has on the broader economy, these circumstances promote the perception that the fiscal regime is not delivering the outcomes expected of it. This may or may not be a valid perception but it is not capable of validation until we promote the equitable distribution of revenue across our country\(^6\).


\(^6\) At the NEFC, we pride ourselves as a lead government agency influencing public policy in Papua New Guinea on intergovernmental financing arrangements. Our main function is to provide independent policy advice to the national government on the distribution of operational (goods and services) grants to the provinces and to local-level governments.

We believe that the primary role of any government of the day is to provide adequate funding to meet the cost of delivering basic services to its people. Some of these critical services include; maintaining rural roads and airstrips, distributing school materials, maintaining rural health facilities, drug distribution to the health centres and aid posts, extension training to rural farmers and operational materials for the village courts. These are examples of essential services that are critical to the livelihood of Papua New Guineas.

Over time our work has served as a resource for academics, policymakers, related agencies of government, donors, the
The NEFC made following observations in its 2013 Budget Fiscal Report:

“In conclusion, the constitutional grants to provinces and local level governments which the NEFC closely monitors in collaboration with the Departments of Treasury, Finance and Provincial Affairs, only comprises of just under 4% of the entire national recurrent budget. I continue to be of the view that if a similar level of rigorous scrutiny is placed on over the remaining other 96% of the budget, significant amount of funds may be saved and ploughed back into service delivery for the benefit of a majority of PNG’s population.”

Our hope is that, as we commence LNG exports this year and enter the 2015 National Budget formulation period, we promote the equitable distribution of revenue in keeping with the principles and policies promoted by the NEFC and the aspirations expressed in our Constitution.

**Marginal Field Development**

There are a large number of discovered oil and gas pools which remain undeveloped to date and have serious prospects of not being commercialised in the foreseeable future. Oil Search recommends that the Committee considers various policy options to accelerate the commercialisation of these discoveries. A more benign fiscal regime in the form of lower tax rates or wider ring fencing provisions to allow the development cost of these discoveries to be consolidated with existing projects are some of the policy alternatives. As the largest investor in exploration in PNG, Oil Search is gratified with this thinking and is keen to assist the Committee with information and economic analysis to enable a research-based policy initiative.
Section 14: Conclusion

For the past 20 years, the oil and gas industry has been a catalyst for the country’s economic development. It not only has provided significant tax revenue and given the State valuable commercial assets by virtue of State equity participation; more importantly it has stimulated private sector investment in country. There is no better example of this than the PNG LNG Project which created a construction and services industry boom in the country even before a single dollar of revenue was derived by the project owners. The associated benefits from these types of projects in terms of increased employment levels and local business development creates confidence in the PNG economy and provides a platform for continued economic growth beyond the resources sector.

Oil Search has been exploring in PNG for the last 85 years and currently operates Kutubu oil fields, Gobe oil fields, Moran oil fields, Mananda oil field and the Hides Gas to Electricity Project, in other words, all producing projects other than the recently commissioned PNG LNG Project. Oil Search employs over 3000 people and has an extensive sustainability programme. Over the last 22 years, since PNG’s first oil in 1992, the oil projects have provided a constant source of tax revenue to the Government totalling over Kina 13 billion and a stream of direct benefits to the landowners totalling over Kina 2.8 billion. Oil Search’s continued investment in near-field exploration has helped reduce the decline in oil-field production and has extended the life of these oil fields. The oil business has provided contractors and suppliers sustained business for all these years maintaining the level of economic activity and source of tax revenue for the nation. Oil Search’s commitment to local business development has seen successful businesses being owned and managed by landowner companies around logistics, security, construction and catering.

In particular, Oil Search has in just the last three years paid more than US$800 million to the Government, US$200 million to landowners, has 63% national employees, has spent more than US$40 million on sustainable development activities and community infrastructure and has donated more than US$20 million to the Oil Search Health Foundation. However, these numbers pale in comparison to the potential Government cashflows derived from the PNG LNG Project which could amount to Kina 184.5 billion over the project life. In that context, it is clear that there is enormous benefit to the country from a Government policy that maintains stability, encourages investment and results in the development of more large resource projects.

The key challenge for any government in a resource based economy is to maintain and build on exploration and development momentum. This is most likely to be achieved if there an ongoing slate of large resource projects which are delivered in a predictable manner so the business confidence is not shaken. Projects provide significant revenue flow to the Government to underpin spending on economic development, but more significant is the stimulus and business confidence that these projects create. As we highlighted in our introduction to this paper, as PNG focusses on achieving its goals as set out in the Papua New Guinea Development Strategic Plan 2010-2030 and the Papua New Guinea Medium Term Development Plan, it will be critical for PNG to identify and foster these new projects. This Tax Review provides an opportunity to create a platform for those future projects, but it also presents a risk to that future growth if the policy adopted is short-sighted and is only focussed on increasing the Government’s percentage take, as opposed to growing the pie which all parties share in.
PNG has natural challenges in dealing with the issue of decentralization and Provincial and Local level Government and as a consequence faces significant issues in the capacity and capability to deliver services and build and maintain social infrastructure in its Districts and Provinces. It is against this backdrop that Special Support Grants and now Royalties from the oil industry have been directed to the Provincial Governments and LLGs. The financial windfall from the oil industry may not have translated into development outcomes in the impacted Districts and Provinces. This perpetuates the false perception that the fiscal regime heavily favours the extractive industry. Increasing the royalties paid by resource companies is not a panacea as that just magnifies the challenge already faced by the Provinces in administering the revenues from the oil industry. Institutional reform is a priority in dealing with these challenges.

Policy measures not only involve an appropriate fiscal regime and exploration incentives, but also consistency and predictability. Typically, it takes 20+ years from the drilling of the first well to the export of first cargo of LNG (oil takes less, but new significant oil discoveries are becoming rarer in PNG which has proven to be largely a gas province). A new investor in the country will be looking at the current fiscal regime and make predictions of what it would be for the next 10+ years. Its board and shareholders will examine what has happened in the past and add a risk weighting in its NPV analysis. It is in this respect that structural changes in the fiscal regime (such as the ones proposed in this Issues Paper) even with the noble goal of simplification or harmonisation deplete NPV values by adding to uncertainty.

With that background in mind, it is important that the Government does not experiment with the fiscal regime and cause uncertainty amongst investors in PNG. The current system is well balanced and progressive. There are some areas of minor reform which we support but fundamental structural changes are not required and will be counter-productive. The Government is about to access a revenue stream from the PNG LNG project that is unprecedented in PNG history and the country would be best placed if there are future projects of similar size and profitability. We again highlight that the macroeconomic setting, high cost basis, geological prospectivity and challenges from competing international projects is making these large petroleum developments more challenging.

In considering their reform agenda, the Government should continue to focus on expanding the tax base (as opposed to the tax rate) and the allocation of benefits in an efficient and effective manner. Through the delivery of better infrastructure, PNG can access much of latent capacity in the economy, particularly in the agricultural sector.

Oil Search sees itself more than just a taxpayer. We consider ourselves an important development partner with our nation. Our responsibility does not end at payment of the tax cheque. It is our corporate priority to partner with the State in delivering meaningful projects across the nation for sustained long term development in the furtherance of the State’s development goals. Oil Search is helping the State to achieve its goals by ploughing back a substantial portion of its revenue into exploration and also in acquiring and building its PNG resource base.

Our recommendations to the Tax Review Committee are as follows:

- Do not make structural changes such as removing State Participation and APT and bringing in a new fiscal instrument;
• Focus on broadening the tax base by utilising policy to help to deliver more projects and at a faster rate;
• Concentrate on the management of benefits and delivery of infrastructure as opposed to an increased share of the benefits ‘pie’; and
• Do not create new and unmanageable stakeholder expectations by introducing 20% commercial equity for landowners instead of the current 2% free equity