

In Confidence

Office of the Minister of Energy and Resources  
Office of the Minister of Revenue

Chair, Cabinet Economic Development Committee

## **Extending tax exemption for non-resident offshore oil rig and seismic vessel operators**

### **Proposal**

- 1 At present, there is a temporary five-year exemption from income tax on the income of non-resident offshore oil rig and seismic vessel operators which is due to expire on 31 December 2019. We propose that the exemption be extended for a further five years from 1 January 2020 until 31 December 2024.

### **Executive Summary**

- 2 At present, there is a temporary five-year exemption from income tax on the income of non-resident offshore oil rig and seismic vessel operators which is due to expire on 31 December 2019. The exemption removes the incentive for rigs and seismic vessels to “churn”, that is, move in and out of New Zealand waters within 183-days to ensure income is exempt from income tax under many of our double tax agreements (DTAs).
- 3 In the absence of the tax exemption no company tax would be paid by the oil rig and seismic vessel operators, while the increased costs from churning would be deductible to the New Zealand petroleum company and the reduced exploration and production may result in lower company taxes, petroleum royalties, and other taxes being paid over time.
- 4 A decision to extend the income tax exemption would be in keeping with the announcement that there will be no new offshore petroleum exploration permits granted, which included maintaining the existing and subsequent rights of existing operators. Where further offshore petroleum exploration is undertaken under existing permits, it is in New Zealand’s interest for this to be done as efficiently as possible, without having policies that encourage churn.

### **Background**

- 5 The tax exemption was introduced in 2004 to address an issue created by our DTAs, under which operators are only taxable in New Zealand if they are present here for at least 183 days. The exemption was subsequently renewed in 2009 and again in 2014 on the basis that this provides a more sensible result from a tax policy perspective. As the exemption is due to expire again on 31 December 2019, a decision is required on whether the exemption should continue to apply.

- 6 New Zealand generally taxes non-residents on income that has a source in New Zealand and if the non-resident has a “permanent establishment” in New Zealand. Many of our DTAs (such as the New Zealand/United States DTA) have a specific rule providing that a non-resident enterprise involved in exploring for natural resources only has a permanent establishment in New Zealand if they are present for a particular period of time, often 183 days in a year. Once a non-resident has a permanent establishment in New Zealand, it is taxed on all its New Zealand business profits starting from its first day in New Zealand.
- 7 Before the exemption was introduced rigs and seismic vessels used in petroleum exploration and production were leaving New Zealand waters before the 183 day threshold was reached to avoid being subject to New Zealand tax. This meant that, in most cases, a rig or vessel would leave before 183 days and a different rig or vessel was mobilised to complete the exploration/production programme, if required. This increased the cost for companies engaged in exploration and production and delayed exploration drilling and any subsequent discovery/development of oil or gas. It also meant that there was no company tax revenue collected from rigs and seismic vessels. Due to the limited supply of offshore drilling rigs, and the significant mobilisation costs, it could also result in exploration activity not taking place when it otherwise would.

## Comment

- 8 Rigs and seismic vessels are used to drill for oil and gas and gather data on potential oil and gas finds. These rigs and vessels do not generally work offshore in winter weather for safety reasons. No New Zealand companies own these assets, and offshore rigs and seismic vessels owned by non-residents are covered by the current income tax exemption.
- 9 Between 2009 and 2017, there have been nine non-resident offshore drilling rigs operating in New Zealand. The average length of stay of these rigs has been 315 days. By contrast, between 2000 and 2005 (before the exemption was introduced), no rigs stayed in New Zealand waters beyond six months. At this stage it is anticipated at least one rig will operate within New Zealand waters in 2019-20.
- 10 Twelve seismic vessels have operated in New Zealand since 2009 with an average duration of 108 days with one high-value survey extending through to 200 days. Before 2005, the average length of stay was around four months. Maintaining the exemption removes a barrier for lengthier stays (which have been fewer but are typically more lucrative).
- 11 A consistent application of New Zealand’s tax policy framework would normally minimise any distortions caused by tax rules. However, with rigs and seismic vessels used for exploration or production work the normal tax rules do not provide the right outcome. This is because the normal tax rules create an incentive for rigs and seismic vessels to “churn”, that is, move in and out of New Zealand waters within a 183 day period where income is exempt under many of our DTAs. If rigs and seismic vessels churn in and out of New Zealand waters within the non-taxable period of 183 days it will reduce the revenue base, and increase unnecessary costs and greenhouse gas emissions.

- 12 Under the exemption, royalties, income tax and other indirect taxes would still be payable in relation to any petroleum discoveries (in addition to the direct and indirect economic benefits from the activity), as the exemption only applies to the non-resident rig and seismic vessel operators rather than the petroleum miner.
- 13 The 2015 APEC fossil fuel subsidy reform peer review of New Zealand noted that this exemption appears to prevent ‘churning’ or cycling of equipment which avoids unnecessary costs, including additional fuel consumption (i.e. wasteful consumption by drilling operators), and associated greenhouse gas emissions. The OECD lists this measure as a “support measure” but has attributed a zero fiscal cost to New Zealand for each year since 2006.

*Environmental impact, health and safety and security of supply*

- 14 Offshore drilling for petroleum in New Zealand began in the 1960s. To date, over 200 offshore wells have been drilled in New Zealand, 10 of which have been in deep water, without any significant incidents. New Zealand also has high health and safety standards with respect to oil and gas exploration and production. This is evidenced in our tight regulation and monitoring of operators and our absence of oil and gas environmental disasters. However, we note that rig mobilisations, demobilisations, and other movements (that occur as a result of churn) increase health and safety risks due to the activities and large infrastructure assets involved. If the exemption is allowed to lapse we would expect increased churn, and therefore increased, but still a low probability of, health and safety risks.
- 15 New Zealand’s gas reserves are only sufficient to cover a decade of annual gas demand at current demand levels. To prevent the situation of gas reserve depletion interrupting our energy supply, new sources of gas may need to be found within the next few years. This may be by way of new gas finds, or extension of existing fields, but either of which will involve some lead-time to production.

*Consistency with recent Government announcement on no new offshore petroleum exploration permits*

- 16 On 12 April 2018 the Government announced there will be no new offshore petroleum exploration permits granted. The Cabinet Minute [CAB-18-MIN-0162 refers] confirms this policy is not intended to affect the rights of current permit holders to continue production or exploration activities under existing permits.
- 17 A decision to extend the income tax exemption would be in keeping with the policy to maintain the rights of existing operators. Where further offshore petroleum exploration is undertaken under existing permits, it is in New Zealand’s interest for this to be done as efficiently as possible, without encouraging churn.
- 18 Instead of a further five-year extension we also considered making the exemption permanent. We consider a five year extension is more prudent as this will provide sufficient certainty for near-term investment decisions while allowing time to consider and develop the Tax Working Group’s recommendations, related to improving environmental and ecological outcomes.

**Consultation**

- 19 Targeted consultation has been undertaken with the oil and gas industry representative body, the Petroleum Exploration and Production Association of New Zealand (PEPANZ), which supports extending the exemption. PEPANZ has also submitted in support of this exemption to the Finance and Expenditure Committee in their consideration of the Taxation (Annual Rates for 2019–20, GST Offshore Supplier Registration, and Remedial Matters) Bill.
- 20 Inland Revenue, the Ministry of Business, Innovation and Employment, the Treasury and the Ministry for the Environment have been consulted and support the proposed 5-year extension.

**Financial Implications**

- 21 This proposal would give rise to \$16 million in tax revenue over the current forecast period. Based on the information available on rig activity, extending the exemption could reduce costs to the New Zealand purchasers of rig services of approximately \$14 million per year with flow-on effects for the tax base. The flow on effects of reduced tax revenue from expiry of the exemption have already been included in the baseline tax forecasts. The table below shows the forecast revenue gains of instead extending the exemption. The final year of revenue impact is 2023/24, when the extended exemption expires.

	\$m - increase/(decrease)				
Vote Revenue Minister of Revenue	2018/19	2019/20	2020/21	2021/22	2022/23 & Outyears
Crown Revenue and Receipts: Tax Revenue	-	4.000	4.000	4.000	4.000

- 22 The revenue gain from this proposal can be accounted for on the tax policy scorecard. The implementation of this policy would increase the cumulate scorecard balance to \$52 million
- 23 Officials’ best judgement is that if the exemption is not extended, rig and seismic vessel operators are likely to resume churning. In this case, no extra revenue would be collected from oil rig and seismic vessel operators while firms purchasing their services are expected to pay less tax. This is because the cost of these services (deductible to the New Zealand purchaser) could increase as a result of rigs and seismic vessels being churned. This expectation is already included in the baseline forecasts.

**Human Rights**

- 24 The proposal is consistent with the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993.

## Legislative Implications

- 25 Extending the exemption before the expiry of the current exemption on 31 December 2019 will require an amendment to the Income Tax Act 2007. The only suitable bill is the Taxation (Annual Rates for 2019–20, GST Offshore Supplier Registration, and Remedial Matters) Bill which has recently been reported back by the Finance and Expenditure Committee (FEC).
- 26 The FEC has accepted the PEPANZ submission to include an extension of the exemption in the Bill. Removing the oil rig exemption from the Bill after the second reading would require Cabinet and Parliamentary support for a Supplementary Order Paper (SOP) at the Committee of the whole House stage. This would have the effect of delaying the progress of the Bill.

## Regulatory Impact Analysis

- 27 A Regulatory Impact Analysis (RIA) is attached.
- 28 The Quality Assurance reviewer at Inland Revenue has reviewed the Extending tax exemption for non-resident oil rig and seismic vessel operators RIA and considers that the information and analysis summarised in it meets the quality assurance criteria of the Regulatory Impact Analysis framework.

## Publicity

- 29 The Minister of Revenue has issued a press release announcing that an extension has been included in the reported back version of the Bill, in response to submissions to the FEC. Inland Revenue will publish details of the new legislation in a Tax Information Bulletin once the tax bill containing the amendments is enacted.

## Proactive Release

- 30 We propose to proactively release this Cabinet paper, together with the associated RIA.

## Recommendations

The Minister of Energy and Resources and the Minister of Revenue recommend that the Committee:

- 1 **Note** that there is an existing temporary income tax exemption for the income of non-resident offshore rig and seismic vessel operators that is due to expire on 31 December 2019.
- 2 **Note** early signalling of intentions is important for industry certainty and investment decisions.
- 3 **Note** that maintaining the exemption would be consistent with the approach to maintaining existing settings taken in the offshore oil and gas exploration announcement made on 12 April 2018.

- 4 **Note** that the Finance and Expenditure Committee has accepted that an exemption be included in the revision tracked version of the Taxation (Annual Rates for 2019-20, GST Offshore Supplier Registration, and Remedial Matters) Bill.
- 5 **Agree** to the exemption for the income of non-resident offshore rig and seismic vessel operators being extended until 31 December 2024.
- 6 **Note** that agreeing to recommendation 5 above will have an estimated revenue gain of \$16 million over the forecast period, which can be accounted for on the tax policy scorecard:

Vote Revenue Minister of Revenue	\$m - increase/(decrease)				
	2018/19	2019/20	2020/21	2021/22	2022/23 & Outyears
Crown Revenue and Receipts: Tax Revenue	-	4.000	4.000	4.000	4.000

- 7 **Note** the last year of revenue impact is 2023/24, when the exemption expires.
- 8 **Note** that this Cabinet paper, the associated Cabinet minute, and Regulatory Impact Assessment will be proactively released on Inland Revenue's website.

Authorised for lodgement

Hon Dr Megan Woods

Minister of Energy and Resources

Authorised for lodgement

Hon Stuart Nash

Minister of Revenue