Regulatory Impact Statement

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

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

It provides an analysis of whether an existing temporary five-year exemption from tax on the income of non-resident offshore oil rig and seismic vessel operators should be extended or left to expire.

The key policy objectives are to ensure that:

- the tax rules do not unnecessarily distort the decisions of non-resident offshore oil rig and seismic vessel operators
- the tax rules do not discourage the offshore exploration for oil and gas in New Zealand
- the scope of the exemption aligns with the policy intent.

The class of taxpayers likely to be affected is limited – namely, those taxpayers involved in offshore oil and gas exploration in New Zealand.

A constraint affecting the consideration of the options is that of time – the existing tax exemption expires at the end of 2014. Accordingly, any extension of the exemption should be enacted before the end of next year. A caveat concerning the analysis is that there is some degree of uncertainty regarding the behaviour of rig operators if the exemption were to be removed. However, the Ministry of Business, Innovation and Employment's best judgement (based on the rig operators' behaviour prior to the introduction of the exemption) is that if the exemption was removed, rig operators are likely to modify their behaviour.

Targeted consultation has been undertaken with the industry representative body. The Treasury and the Ministry of Business, Innovation and Employment have also been consulted.

The recommended approaches to the various issues raised do not impose additional costs on businesses, impair private property rights, restrict market competition, reduce the incentives on businesses to innovate and invest, or override fundamental common law principles.

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10 October 2013

STATUS QUO AND PROBLEM DEFINITION

1. At present, the Income Tax Act 2007 contains a temporary five-year exemption from tax on the income of non-resident offshore oil rig and seismic vessel operators. The exemption was introduced in 2004 and extended in 2009. The exemption is due to expire on 31 December 2014. The measure was introduced as part of a package of temporary measures designed to encourage offshore oil and gas exploration.

Rigs and seismic vessels

2. Offshore rigs and seismic vessels owned by non-residents are covered by the current exemption. They are used to drill for oil and gas and gather data on potential oil and gas finds.

3. Rigs are generally of two types – semi-submersibles and jack-up rigs. There is a worldwide market in rigs and seismic vessels. No New Zealand company owns offshore rigs or seismic vessels, so any company wishing to explore in New Zealand waters needs to use a rig or seismic vessel provided by a non-resident owner.

Current tax settings

4. The exemption was introduced to address an issue created by our double tax agreements (DTAs), under which such operators are only taxable in New Zealand if they are present here for at least 183 days.

5. Ordinarily, a broad-base, low-rate framework applies to the tax system. A consistent application of this framework will normally minimise any distortions caused by tax rules. However, with seismic vessels and rigs used for exploration work, there is a question about whether the normal tax rules provide the right outcome.

6. New Zealand generally taxes non-residents on income that has a source in New Zealand. However, our DTAs provide that non-residents are only taxable on their New Zealand-sourced business profits if they have 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, they are taxed on all their New Zealand business profits starting from day one. Non-resident rig and seismic vessel operators generally have tax indemnity clauses in their contracts with New Zealand exploration companies. This means that the incidence of any tax imposed on a non-resident rig operator is borne by the exploration company operating in New Zealand which engages the rig operator's services.

7. The exemption was introduced to address an issue caused by this DTA provision – seismic vessels and rigs used in petroleum exploration were leaving New Zealand waters before the 183 day limit was reached so they would not be subject to New Zealand tax. This meant that in some cases a rig would leave before 183 days and a different rig was mobilised to complete the exploration programme. This "churning" of rigs within the 183 day period where income is exempt under many of our DTAs increased the cost for companies engaged in exploration; it also delayed exploration drilling and any subsequent discovery of oil or gas. It also meant that there was no revenue collected from seismic vessels and rigs. Because of

the limited supply of offshore drilling rigs, it could also result in exploration activity not taking place when it otherwise would.

Evidence of the effect of the exemption on offshore drilling activity provided by the Ministry of Business, Innovation and Employment

8. Comparing the period since the exemption has been in place (2005-2012) with the 2000-2004 period suggests that the exemption has extended the period that offshore rigs and seismic vessels are staying in New Zealand waters. Between 2009 and 2012, there have been three non-resident offshore rigs operating in New Zealand, with an average length of stay of around eight months. By contrast, between 2000 and 2005 (before the exemption was introduced), no rigs stayed in New Zealand waters beyond six months. There are three rigs confirmed to arrive in New Zealand this summer.

9. The average length of stay for seismic vessels has also extended from four months pre-2005 to eight months post-2005.

10. There have been 17 offshore wells drilled between 1 January 2009 and 30 June 2012. Only one well, the Manaia extended reach well drilled from the Maari platform, has resulted in new reserves being brought to market. The Manaia well was drilled from the Ensco 107 jack-up which had been in New Zealand waters for well over six months when drilling at Manaia commenced (drilling commenced on 1 August 2009 but the Ensco 107 had been in New Zealand waters since October 2007). The well produced 2.3 million barrels of crude oil between 2009 and 2012, generating an estimated royalty take of $4.9 million and corporate tax of $5.5 million over the period. It is unlikely that this Crown revenue would have been generated as soon as it was without the existing tax exemption. In the absence of the exemption, it is likely that this revenue would have been generated at a later time, because of the impact of rig churning delaying exploration and production activity.

11. A major drilling campaign is being prepared for the 2013/14 drilling season with 20 confirmed wells and a further seven wells being classed as contingent, probable or possible. Of the 20 confirmed wells, approximately four to five wells will be drilled by rigs that will have been in New Zealand for over six months. It is likely that these wells would not be drilled in 2014 if the existing tax exemption was not in place. It is likely that there would be a delay in the drilling of these wells if the existing tax exemption was not in place. It is also possible that some wells may not be drilled. If they were drilled at a later date and the exemption removed, it is likely that there would be additional costs relating to mobilising and demobilising churning rigs. The mobilisation and demobilisation costs for an offshore rig are approximately US$10-15 million. The cost of drilling a well is between US$10-150 million.

Modular drilling rigs

12. The current exemption applies broadly to non-resident companies operating seismic vessels and rigs used in drilling wells. As noted above the main rig types are semi-submersibles and jack-up rigs. However, a type of rig (a modular drilling rig) exists that is relatively small, of modular construction and designed to be installed on an existing platform. There is only one such rig in New Zealand. The other platforms on existing fields in New Zealand are too small to accommodate this type of rig. A modular drilling rig does not have the same high mobilisation and demobilisation costs as other rigs.

13. We consider that modular drilling rigs should be excluded from the scope of the current exemption for non-resident oil rig operators. This is because such rigs were never intended to be within the scope of the amendment (which was designed with large rigs, such as semi-submersibles and jack-up rigs, in mind). In addition, as modular drilling rigs do not have the same high mobilisation and demobilisation costs as semi-submersibles and jack-up rigs, the issue of rig churning is not as significant. Accordingly, the rationale for the exemption does not really apply to this type of rig.

Maintaining the status quo

14. If the status quo is maintained (i.e. the temporary exemption is left to lapse at the end of 2014), it is likely that rigs would resume staying in New Zealand waters for less than 183 days, so that the operators are not subject to tax. This would mean that the cost of offshore exploration activity would increase for New Zealand companies that engage offshore rig and seismic vessel services, as a new rig would have to be engaged to continue exploration work. Mobilising and demobilising such rigs has a cost of around $10-$15 million per rig. This would have flow-on effects for the tax base, as the cost would be deductible to the New Zealand company. The churn would also cause a delay in any potential revenue from successful exploration activity. However, this would be offset by the delay in the deductions associated with that additional exploration activity.

15. The root cause of the problem is that the normal tax rules increase costs for business by creating an incentive for seismic vessels and rigs 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.

OBJECTIVES

16. The objectives are to:

1. ensure the tax rules do not unnecessarily distort the decisions of non-resident offshore rig and seismic vessel operators
2. ensure the tax rules do not discourage the offshore exploration for oil and gas in New Zealand
3. ensure that the scope of the exemption aligns with the policy intent.

17. The outcomes are subject to a time constraint. In considering the legislative vehicle and the application date for the amendment, officials have taken into account that the current temporary exemption expires on 31 December 2014. If the exemption is extended, it is preferable for the legislation to be enacted before the current exemption expires.

REGULATORY IMPACT ANALYSIS

18. There are two options that may deal with the problem and achieve the objectives:

1. Make permanent the current tax exemption for offshore non-resident rig and seismic vessel operators and amend the scope of the exemption to carve out modular drilling rigs. *(preferred option)*

2. Extend the current tax exemption for offshore non-resident rig and seismic vessel operators for a further five years and amend the scope of the exemption to carve out modular drilling rigs.

19. *Summary of impacts of options one and two*

Option	*Meets Objective?*	*Impacts*				*Net Impact*
			Fiscal/economic impact	***Administrative/ compliance costs***	***Risks***	
One (making exemption permanent – preferred option)	Yes	Tax system	No fiscal impact, as continuing current exemption. While not directly consistent with broad-base, low-rate tax framework, addresses churning issue caused by 183 day rule in our DTAs, meaning that exploration programmes are less likely to be delayed. No fiscal impact from amending scope as it will protect tax base going forward.	No administrative costs.	May create a precedent for other tax exemptions in the future.	Improves status quo by addressing issue caused by our DTAs, provides certainty to taxpayers and ensures scope of exemption aligns with policy intent.
		Taxpayers	Improves on the status quo by ensuring that costs of rig "churning" are minimised.	No compliance costs.		
Two (extending exemption by five years)	Yes	Tax system	As above	Some administrative costs from reviewing exemption at end of five year period.	As above.	As above but only for a further five years.
		Taxpayers	As above	No compliance costs but less certainty than option one.		
Three (status quo, i.e. let exemption lapse)	No	Tax system	May have negative fiscal impact. If the exemption were removed, rig operators are likely to resume churning. In this case, no extra revenue would be collected from oil rig operators, while firms purchasing their services could pay less tax. This is because the cost of these services (deductible to the New Zealand purchaser) could increase as a result of rigs being churned. Based on the information provided above on the 2013/14 drilling season, letting the exemption lapse could cost the New Zealand purchaser of rig services approximately US$36 million, with flow-on effects for the tax base.[1]	No administrative costs.		Rigs likely to resume churning because of the 183 day DTA rule, with resulting increased cost of offshore rig and seismic vessel services. Delay in Crown revenue collected from royalties and corporate tax on oil and gas production because drilling likely to be delayed.
		Taxpayers	Likely to be an increase in the cost of offshore rig services, which may delay or reduce offshore exploration activity.	Increased compliance costs.		

[1] This is based on the 3 rigs present in New Zealand for the 2013/14 drilling season and the estimated $10-15 million mobilisation and demobilisation costs per rig.

Social, environment or cultural impacts of all options

20. There are no social, environment or cultural impacts to the options. The groups affected by the amendments proposed are non-resident operators of offshore oil rigs and seismic vessels and oil and gas exploration companies which engage such operators.

Net impact of all options

21. The net impact of options 1 and 2 is to ensure that the tax rules do not unnecessarily distort the decisions of non-resident offshore rig and seismic vessel operators and do not discourage the offshore exploration for oil and gas in New Zealand. Options 1 and 2 also ensure that the scope of the exemption aligns better with the policy intent.

22. The net impact of option 3 (the status quo) is likely to be a return to the situation that existed before the exemption was put in place in 2005, which is that rig operators are likely to resume churning, with a resulting increased cost to companies engaged in exploration in New Zealand, with flow-on effects for the tax base.

CONSULTATION

23. 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 making the exemption permanent.

24. The Ministry of Business, Employment and Innovation (MBIE) was also consulted; it supports option 1, as it aligns with the Government's policy of encouraging offshore oil and gas exploration in New Zealand.

25. The Treasury was also consulted and favours option 3 (the status quo of letting the exemption lapse). This is because they consider option 3 is more consistent with the Government's broad-base, low-rate tax strategy. Treasury was also concerned about the precedential effect of extending the exemption. However, it supports modifying the scope of the exemption to exclude modular drilling rigs.

26. Targeted consultation was also undertaken with the sole purchaser of modular drilling rig services in New Zealand, who accepts the rationale for excluding modular drilling rigs from the scope of the exemption, in the context of the exemption being made permanent. Consultation was limited because of the time constraint of ensuring legislation is enacted before the current exemption expires. There will be opportunities for other interested parties to submit on the amendments at the Select Committee stage of the Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Bill.

CONCLUSIONS AND RECOMMENDATIONS

27. Option 1 is the preferred option because it best achieves the policy objectives of ensuring that the tax rules do not unnecessarily distort the decisions of non-resident offshore rig operators and do not discourage the offshore exploration for oil and gas in New Zealand. Option 1 also ensures that the scope of the exemption better aligns with the policy intent.

28. Option 2 is not favoured because, while it achieves the policy objectives and ensures that the scope of the exemption better aligns with the policy intent, we consider that option 1

is preferable as the exemption has already been rolled over once and it will provide more certainty to exploration companies. In addition, there would be administrative costs from reviewing the exemption again in five years.

29. Option 3 is not favoured because it does not achieve the policy objectives.

IMPLEMENTATION

30. The amendments will be implemented through the Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Bill, expected to be introduced in November this year. The amendments would have an application date of 1 January 2015, being the date that the existing temporary exemption ceases to apply.

31. There should be no significant implementation issues with the amendment. Inland Revenue will communicate the change in rules to taxpayers and tax agents through existing channels, such as the *Tax Information Bulletin* and through updating its guides.

32. Enforcement of the proposed changes will be managed by Inland Revenue as business as usual and there will be no specific enforcement strategy required.

MONITORING, EVALUATION AND REVIEW

33. There are no specific plans to monitor, evaluate and review the changes under the Income Tax Act 2007 following the changes.

34. If any detailed concerns are raised, officials will determine whether there are substantive grounds for review under the Generic Tax Policy Process (GTPP).

35. In general, Inland Revenue monitoring, evaluation and review of new legislation takes place under the Generic Tax Policy Process (GTPP). The GTPP is a multi-stage tax policy process that has been used to design tax policy in New Zealand since 1995. The final stage in the GTPP is the implementation and review stage, which involves post-implementation review of the legislation, and the identification of any remedial issues. Opportunities for external consultation are also built into this stage. In practice, any changes identified as necessary for the new legislation to have its intended effect would generally be added to the Tax Policy Work Programme, and proposals would go through the GTPP.