

Regulatory Impact Statement

Amendment to the tax treatment of underground gas storage facilities

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

It provides an analysis of options to address a gap in the petroleum mining tax rules – this gap currently allows expenditure on constructing an underground natural gas storage facility to be deducted over a concessionary seven year period, as petroleum development or exploration activity. This is contrary to the policy intent, as the storage of processed gas is not a petroleum development or exploration activity.

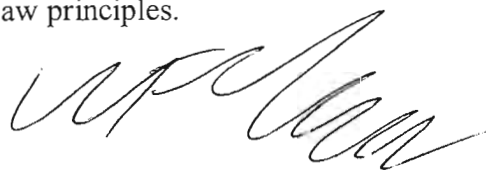
The key policy objective is ensuring that expenditure on underground natural gas storage facilities is deductible over the economic life of the asset, in line with policy intent.

The class of taxpayers likely to be affected is limited – namely, those taxpayers in the petroleum industry who seek to store gas underground, after production.

There are no significant constraints, caveats or uncertainties concerning the regulatory analysis undertaken. 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.

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

There are no other significant constraints, caveats and uncertainties concerning the regulatory analysis undertaken. 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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STATUS QUO AND PROBLEM DEFINITION

1. The current petroleum mining tax rules provide concessions to encourage the exploration for, and subsequent development of, petroleum reserves in New Zealand. The policy issue is that a gap in the rules allows for expenditure on underground natural gas storage facilities to be deducted over a concessionary seven-year period. This is contrary to the policy intent that only expenditure on petroleum exploration or development should be deductible over a seven year period. This is because the underground storage of gas that has already been extracted and processed is not an exploration or development activity.
2. An underground gas storage facility enables processed gas to be injected into the storage facility during periods when demand is low or when renewable energy is abundant. This increases flexibility in supplying gas for electricity generation. The gas has been extracted (a royalty being paid to the Crown on extraction), and processed before being injected into the storage facility.
3. Underground facilities are commonly used in other countries to store gas, as they are more economical than alternative storage options. At present, there is only one underground gas storage facility in New Zealand. However, we understand that at least one other energy company may possibly be interested in using depleted fields in New Zealand (onshore or offshore) for storing natural gas.
4. If the status quo was retained, expenditure on underground gas storage facilities would continue to be deductible over a concessionary seven year period, contrary to the policy intent.
5. The root cause of the problem is that there is a gap in the tax rules which means that underground gas storage facilities fall within the concessionary petroleum mining rules instead of under the depreciation rules (which allow deductions to be spread over the economic life of an asset).

OBJECTIVES

6. The objective is to ensure that expenditure on an underground gas storage facility is spread over the economic life of the facility, in accordance with the policy intent.
7. The outcomes are not subject to any constraints, with the exception that, in considering the application date for the amendment, the circumstances of the one existing underground gas storage facility in New Zealand have been taken into account.

REGULATORY IMPACT ANALYSIS

8. There are two options that may deal with the problem and achieve the objectives:
 - a) Exclude underground facilities that store processed gas from the petroleum mining rules and include these within the depreciation rules, with an economic life determined by the Commissioner of Inland Revenue. (*preferred option*)
 - b) Exclude underground facilities that store processed gas from the petroleum mining rules and include these within the depreciation rules, with a set economic life of 40 years.

Option one (preferred option)

9. This option involves excluding underground facilities that store processed gas from the petroleum mining rules, and including these facilities within the depreciation rules. The economic life of the asset (over which deductions for expenditure would be spread) would be set by the Commissioner of Inland Revenue under the tax rules for determining depreciation rates applicable to items of depreciable property. As part of this, taxpayers could also apply to the Commissioner for a special rate. This option achieves the policy objective of ensuring deductions for expenditure on an underground gas storage facility are spread over the economic life of the asset.

10. The amendment is largely for base maintenance and is not expected to have any fiscal impact.

Option two

11. This option involves excluding underground facilities that store processed gas from the petroleum mining rules and including these within the depreciation rules, with a set economic life of 40 years. This economic life is based on the Australian tax rules for underground gas storage facilities, which treat such facilities as depreciable assets with an estimated life of 40 years.

12. The amendment is largely to protect the revenue base going forward and is not expected to have any fiscal impact.

Summary of impacts of options one and two

Option	Meets Objective?	Impacts				Net Impact
		Fiscal/economic impact	Administrative/ compliance costs	Risks		
One	Yes	Tax system	No fiscal impact, as protecting revenue base going forward.	No administrative costs.	None	Improves status quo by ensuring tax rules align with policy intent.
		Taxpayers	Taxpayers incurring expenditure on underground gas storage facilities must spread deductions over the economic life of the asset, instead of over concessionary 7 years.	May be some transitional compliance costs.		
Two	Yes	Tax system	No fiscal impact, as protecting revenue base going forward.	No administrative costs.	Insufficient flexibility to allow a taxpayer to apply for a special rate (taking into account that the economic life may vary for different underground gas storage facilities).	Improves status quo by ensuring tax rules align with policy intent.
		Taxpayers	Taxpayers incurring expenditure on underground gas storage facilities must spread deductions over 40 years, instead of over concessionary 7 years.	May be some transitional compliance costs.		

Social, environment or cultural impacts of both options

13. There are no social, environment or cultural impacts to the options. The groups affected by the amendments proposed are energy companies seeking to store gas underground post-production.

Net impact of both options

14. The net impact of both options is to ensure that expenditure on underground gas storage facilities is correctly treated under the tax rules, without causing a negative economic impact for taxpayers.

CONSULTATION

15. Targeted consultation has been undertaken with interested parties and the industry representative body, seeking feedback on the proposed approach and what an appropriate economic life for an underground gas storage facility would be. In addition, consultation covered transitional issues in shifting from the current treatment to the proposed treatment, and the application date for the amendment.

16. There was recognition of the policy rationale for spreading deductions for expenditure on underground gas storage facilities over the economic life of these assets. Concerns were raised about the possibility of the legislation specifying one period over which deductions could be spread – the concern was that this approach would not take into account the specific features of each underground gas storage facility. Therefore, submitters preferred an approach which would allow taxpayers to apply to the Commissioner of Inland Revenue for a special rate.

17. Consultation on the application date also resulted in grandparenting for the owner of the one existing natural gas storage facility in New Zealand. The owner has an existing underground storage facility for which it has already incurred expenditure, and it already has a mining permit identifying future expenditure to be incurred on the facility.

CONCLUSIONS AND RECOMMENDATIONS

18. Option one is the preferred option because it achieves the policy objective in a simple and effective manner. Option two is not preferred because it does not provide sufficient flexibility to allow taxpayers to apply to the Commissioner for a special rate, based on the specific features of their underground gas storage facility.

IMPLEMENTATION

19. There is one transitional issue regarding the treatment of proceeds received from the sale of an underground gas storage facility. Such proceeds are currently treated as being on revenue account (taxable) under the petroleum mining rules. Under the proposal, which seeks to remove underground gas storage facilities from the petroleum mining rules, the sale of an underground gas storage facility will change to being on capital account but with claw-back of past depreciation deductions.

20. Accordingly, we consider there should be a rule providing for apportioning proceeds received from the sale of an underground gas storage facility, to reflect the change in treatment of the asset. For example, if \$250m was incurred under the old rules, and \$50m is

incurred under the new rules, the amount of taxable income from selling a gas storage facility would be: 250/300 multiplied by the sales proceeds.

21. The amendment will be implemented through a tax bill introduced this year. The amendment would apply from the date of enactment, with a grandfathering provision for planned expenditure incurred in relation to the one existing underground gas storage facility in New Zealand.

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

MONITORING, EVALUATION AND REVIEW

23. There are no specific plans to monitor, evaluate and review the changes under the Income Tax Act 2007 following the changes, given that this is an isolated base maintenance issue.

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

25. 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.