

# Submission to the Review of Business Taxation

## Discussion Paper 2 [FOR PUBLIC RELEASE]



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# CONTENTS PAGE

<b>Executive Summary .....</b>	<b>1</b>
Description of Business Activities .....	1
General Comments.....	1
A Platform for Consultation	
Recommendations.....	2
<b>General Comments.....</b>	<b>3</b>
The Impact of Taxation on Investment Decisions .....	3
The Benefits of GST for the Petroleum Exploration and Production Industry.....	3
<b>A Platform for Consultation .....</b>	<b>5</b>
Exploration Expenditure .....	5
Company Tax – Reduction to 30 per cent.....	5
Policy Framework for Wasting Assets	
Retention of the balancing charge provisions in the event of involuntary disposals .....	6
Should Special Rules apply to long life resource projects, in particular gas projects .....	6
Over what period should Assets be Written-Off?.....	8
Case Study – North West Shelf Expansion Project – Australian	
Economic and Fiscal Impacts .....	9
LNG Competitiveness.....	10
Impact of effective life depreciation on an LNG Project.....	10
Viability of projects – Australian Impact.....	12
State-by-State Economic impact of losing accelerated depreciation .....	13
Who should be entitled to deductions? .....	14

# Executive Summary

## Description of Business Activities

Woodside Energy Ltd (Woodside) is operator and major participant in the North West Shelf Ventures (NWSV). The company is responsible for all exploration, development and production of oil and gas reserves from the NWSV offshore exploration and production licence areas. Major products from the North West Shelf include natural gas, LNG, crude oil, condensate and LPG. Woodside also has extensive exploration and development interests outside the NWS, including the Laminaria oil field development in the Timor Sea which is due to commence production during the fourth quarter of 1999.

Woodside's discovery of the North Rankin, Goodwyn and Angel gas fields in the early 1970s led to the development of Australia's biggest resource project – the North West Shelf Gas Project. Sales of natural gas into the WA domestic market commenced in 1984. Exports of LNG to Japan commenced under long term contracts in 1989 and oil production from the Wanaea and Cossack oil fields commenced in 1995.

As operator on behalf of the NWSV, Woodside is responsible for the management of all offshore and onshore production assets, including the North Rankin A and Goodwyn A offshore gas drilling and production platforms, the Cossack Pioneer oil and gas production facility, a 134km subsea trunkline and onshore plant for the processing of natural gas, condensate, LNG and LPGs.

## General Comments

- At a meeting of the Focus Group in respect of Wasting Assets that was held on 16 March 1999 in Canberra, representatives of the Review of Business Taxation suggested that the analysis of investment discussions should be undertaken on a pre-tax basis. In Woodside's experience, this is not the current practice. The timing and magnitude of cash flows resulting from tax is critical to the analysis and investment decision. The use of a pre-tax discount rate, adjusted to take into account the rate of tax, is not an accurate substitution for the impact of the timing of deductions on cash flows and project value.
- The proposed introduction of a goods and services tax (GST) will only provide a marginal benefit (if any) to the Petroleum Exploration and Production Industry. Woodside strongly recommends against any attempt to justify the offset of any losses that may arise as a result from changes to the company tax system against "perceived" benefits that are incorrectly believed to accrue from the introduction of a GST.

## **A Platform for Consultation**

### ***Recommendations***

- The immediate and full write-off of expenditure associated with exploration correctly acknowledges the risk and importance of such activities. The current provisions are entirely appropriate and indeed essential if the current level of activity is to be maintained.
- Woodside supports the Federal Government's objective of moving towards a 30 per cent rate of company tax. To maximise the benefits of the lower rate, the Government must ensure that it has a taxation framework that encourages investment and does not act as a bias against long term investment.
- The balancing charge provisions allow disposal proceeds/insurance recoveries to be offset against the cost of replacement assets. Woodside recommends that these provisions be maintained in the event of involuntary disposals.
- There is clearly a case for applying special rules to long life projects, in particular gas projects. A study completed by the Aberdeen University Petroleum Economic Consultants concluded that the Australian company tax system introduces a significant element of regressiveness which leads to gas projects becoming less profitable due to the depreciation provisions. This unsatisfactory outcome would be maintained under a lower company tax/effective life depreciation schedule regime unless additional value measures were put in place to achieve international fiscal competitiveness for gas projects.
- Current depreciation schedules should be maintained for the resource sector. The increased level of resource sector investment attracted by maintaining current depreciation schedules in a low tax environment will generate superior community benefits as compared to an outcome that trades off depreciation schedules against a lower company tax rate.
- The discussion paper recognises the fact that the ownership basis for depreciation and other capital allowances has created difficulties and commercial uncertainties. Woodside supports a change in accordance with Option 1 that provides for the person who incurs the expenditure on the asset to claim the deduction.

# **General Comments**

## **The Impact of Taxation on Investment Decisions**

At a meeting of the Focus Group in respect of Wasting Assets that was held on 16 March 1999 in Canberra, representatives of the Review of Business Taxation suggested that the analysis of investment decisions should be undertaken on a pre-tax basis. In Woodside's experience, this is not the current practice. Such an approach represents a fundamental misunderstanding of the importance of taxation in establishing the commercial viability of projects, in valuing projects and in establishing the international competitiveness of projects.

The analysis of investment decisions is generally conducted using discounted (real value) after tax cash flows. The timing and magnitude of cash flows resulting from tax is critical to the analysis and investment decision. The use of a pre-tax discount rate, adjusted to take into account the rate of tax, is not an accurate substitute for the impact of the timing of deductions on cash flows and project value.

If project analysis is done on a pre tax basis there would be no argument about the merits of an accelerated depreciation regime versus an effective life depreciation regime. These differences are only reflected in an after tax analysis. The fact that such an argument arises is evidence of the use of after tax analysis.

## **The Benefits of GST for the Petroleum Exploration and Production Industry**

The proposed introduction of a goods and services tax (GST) will potentially impact on the cost base of operations in the Petroleum Exploration and Production industry on two levels.

On the first level, and assuming that the GST does not impose an additional taxation burden on the industry, there is expected to be at best a very marginal reduction in the level of indirect taxation. As the relative share of indirect taxes is small (around 5% of the total value of tax payments), and recognising that the high cost indirect taxes that are incurred by the industry are to remain in place following the introduction of GST (ie tariffs), this first level of benefits is therefore expected to be very modest.

It also needs to be recognised that the nature of activities carried-out in the petroleum exploration and production operations are generally not land transport fuel intensive (particularly when compared with the mainstream onshore mining sector). The removal of diesel fuel excise, while potentially providing some avenue for cost reduction to the industry, again will only provide a relatively marginal benefit.

The second level of benefit associated with the introduction of a GST involves a possible reduction in the cost of business inputs as a result of a flow-through of lower taxes on supply activities. While it is recognised that some level of benefit may exist, the nature of activities in the industry may again dampen the overall impact. This is particularly the case due to the source of many of the inputs used in the industry, which are obtained from overseas supply points.

The full benefits associated with a reduction of business input costs can only be fully achieved for the Petroleum Exploration and Production Industry if there is a corresponding reduction in the level of customs and excise duties that currently apply to goods.

Woodside's judgement is also supported by the Department of Industry, Science and Resources (DISR). In comparing the oil and gas sector benefit with the coal industry, DISR advised that *"..the upstream petroleum sector contribution to the figure (ie the net gain) is not as large as that of the coal industry where transport is likely to be a more significant component of costs."*

**Woodside strongly recommends against any attempt to justify the offset of any losses that may arise as a result from changes to the company tax systems against "perceived" benefits that are incorrectly believed to accrue from the introduction of a GST.**

# A Platform for Consultation

In addressing the issues raised in the document A Platform for Consultation – Discussion Paper 2, the following comments are provided.

## Exploration Expenditure

Exploration is an essential element of conducting business in the Petroleum Industry. Exploration can cover a range of activities including regional surveys, geophysical evaluation, seismic operations, exploration drilling and field appraisal.

As an indication of the significance of exploration activities, data from the Australian Bureau of Statistics indicates that exploration costs incurred in petroleum exploration operations for 1997/98 totalled slightly less than \$1 billion, or around 25 per cent of pre-tax operating expenditures.

The immediate and full write-off of expenditures associated with exploration correctly acknowledges the nature and importance of such activities. Such outlays are a direct cost of conducting the business and their immediate deductibility is appropriate.

The consequence of removing the immediate deductibility would be a highly distortionary disincentive to risk-taking that would ultimately reduce the overall exploration effort in Australia, particularly in those areas where risks are perceived to be higher. Exploration would likely be reduced in 'greenfields' and frontier areas where the likelihood of success is more uncertain. This would clearly be at odds with general energy policy objectives of resource security and diversifying sources of supply.

Support for existing tax treatment of such costs has been extensive over the last two decades. In particular, the Industry Commission and its predecessors have strongly endorsed the continuation of the present provisions. Exploration costs are critical to the resource sector and any outcome other than immediate and full deductibility would be inequitable and distortionary.

**Woodside recommends that the immediate deductibility for exploration expenditure should be maintained as it is entirely appropriate and indeed essential if the current level of activity is to be maintained.**

## Company Tax – Reduction to 30 per cent

Woodside supports the Federal Government's objective of moving towards a 30 per cent rate of company tax. To maximise the benefits of the lower rate, the Government must ensure that it has a taxation framework that encourages investment. Specifically, the taxation system should not act as a bias against long term investment.

## Policy Framework for Wasting Assets

- **Retention of the balancing charge provisions in the event of involuntary disposals**

Section 42-30 requires a balancing adjustment to be calculated for a unit of depreciable plant if it is lost or destroyed. Sections 42-190 and 42-195 provide for assessable or deductible balancing adjustments where the “Termination value” exceeds or is less than the written down value of the plant respectively. Section 42-205 defines “termination value” in the case of plant lost or destroyed to be the amount or value received or receivable under an insurance policy or otherwise for the loss of destruction.

Where an insurance recovery exceeds the written down value, the excess is only assessable to the extent of previously claimed deductions. If the insurance recovery exceeds the original cost, it will be subject to the ordinary CGT provisions.

Sections 42-285 and 42-290 allow taxpayers to effectively defer any assessable balancing charge by instead reducing the cost, or written down value of replacement or other plant by the otherwise assessable balancing charge.

Woodside firmly believes that these provisions should be maintained in the event of involuntary disposals. To highlight the importance of this issue, we can look at the hypothetical situation of the total loss of an offshore facility. Under the above stated provisions, any insurance proceeds received would be offset against the cost of the replacement facility. If these provisions were removed and the insurance proceeds became assessable upon receipt, 36% of the proceeds would have to be paid in tax, leaving insufficient funds to rebuild the offshore facility. This situation would be clearly unacceptable.

**Woodside recommends that the balance charge provisions be maintained in the event of involuntary disposals.**

- **Should special rules apply to long life resource projects, in particular gas projects?**

Investments in gas projects are fundamentally different to those in virtually any other type of business enterprise. Gas projects are often characterised by substantial time lags between discovery and commercialisation of the resource. In the case of Australia, reserves are also often located in geographically remote locations, with vast distances to markets.

In addition to the above factors, gas projects often involve the expenditure of vast sums of capital over long periods, with considerable outlays prior to the commencement of initial production not being uncommon. This is particularly the case for LNG developments. Another factor that differentiates this type of project from many others is that the pay-back period for an investor to achieve a positive economic return is often quite lengthy.

As a result of the characteristics of such projects, project viability is very sensitive to a number of key parameters, including taxation. Because such projects can have lives that are in excess of 20 years, the ability to depreciate the capital cost for income tax purposes fundamentally influences project economics.

The negative impact of Australia's company tax system on the economics of gas projects was demonstrated in a Petroleum Resource Rent Tax study that was prepared for the Department of Primary Industries and Energy by Aberdeen University Petroleum and Economic Consultants (AUPEC).

Specifically, the AUPEC study concluded that the Australian company taxation system introduced a significant element of regressiveness which leads to gas projects becoming less profitable due to the depreciation provisions. Indeed, under a range of representative scenarios, the net present value of company tax collections exceeded the entire pre-tax net present value of the project. In effect, the company tax system (even through the application of relatively low discount rates) can extract the entire economic rent from a gas project.

The study highlighted that even under a relatively modest set of development cost assumptions, the Australian company tax regime is uncompetitive with a range of other gas producing countries.

The following extract from the AUPEC report highlights the difficulty that the corporate tax system can cause to petroleum projects in Australia:

*“Development decisions are made separately from exploration and appraisal decisions. Discoveries often remain undeveloped when prospective returns are inadequate. This study has shown that by far the biggest element of tax on moderately profitable and marginal fields is the corporate income tax. To encourage development of such fields the depreciation arrangements for corporate income tax should be examined. This examination should include the timing of the commencement of the utilisation of the allowances and the total time period over which most allowances have to be taken. While APPEA did not raise this issue the results of the study clearly indicate that the depreciation terms significantly affect the economics of moderately profitable/marginal fields.”*

**Woodside strongly believes that a clear case exists for applying special rules to gas projects. The company tax system introduces a significant element of regressiveness which leads to gas projects becoming less profitable due to the depreciation provisions. This unsatisfactory outcome would be maintained under a lower company tax/effective life depreciation schedule regime unless additional value measures were put in place to achieve international fiscal competitiveness for gas projects.**

- **Over what period should assets be written off?**

In addition to the comments above highlighting the potential impact depreciation provisions can have on the profitability of gas projects, this section of the submission argues the case for maintaining the current depreciation schedules (or introducing similar value measures) whilst moving to a company tax rate of 30%. The increased level of resource sector investment attracted by maintaining accelerated depreciation in a low tax environment will generate superior community benefits to an outcome that simply acts to trade-off accelerated depreciation against a lower company tax rate.

The total benefits flowing to the Australian community from resource sector projects includes the indirect benefits relating to employment growth, stimulation of service industries, additional tax and royalty payments and generation of substantial export income. The results of a case study, based on a typical large scale LNG project, are presented below. The enormous indirect benefits flowing to the community in the case study example are representative of the benefits derived from most resource sector projects of similar scale.

An analysis of the international competitiveness for the LNG industry shows that Australia's depreciation rate in relation to LNG projects is already uncompetitive with those applying to our competitors. Resource sector projects and their benefits may well be lost to Australia if the projects cannot offer attractive after-tax rates of return to international investment capital.

Some \$190 billion of resource sector mining and processing projects are proposed in the period 2001 - 2011 according to information supplied by Access Economics. The impact of depreciation rate changes on a suite of hypothetical resource sector projects and how changes to depreciation rates may impact on the viability of those projects is also outlined below. There is a strong case for maintaining accelerated depreciation for long term projects while at the same time moving towards a lower company tax rate. Indeed, it is suggested that maintaining accelerated depreciation for long term petroleum projects in a low tax environment is likely to be more than offset by the additional revenues (both income and resource taxes) flowing from projects otherwise rendered uneconomic by a depreciation/tax rate trade-off.

## Case Study: North West Shelf Expansion Project - Australian Economic and Fiscal Impacts

This section draws on results contained in a report by Access Economics produced in October 1997. The assumptions in the report reflect the then current conditions of market demand and energy prices, which have now changed considerably. None-the-less, the analysis still validly reflects the community benefits of a large-scale resource sector project, albeit that the profitability to the proponents is considerably lower than implicit in the case study. Community benefits will be delayed to the extent that the project timetable slips beyond that envisaged in the report.

Base assumptions:

Construction of a two LNG train export facility on the Burrup Peninsula in north-west Australia with some \$6.5 billion of capital (1998 prices) being expended over the period from present to 2007. Capital is supplied largely (some 75%) by foreign investors and (for the purposes of conservatively modelling the community benefits) is assumed to be 100% debt financed. Additional revenues associated with 7 million tonnes p.a. LNG export are some \$2 billion p.a.

Key economic results:

- Peak construction year employment impact: **+ 10,000 jobs**
- Additional export earnings to 2022: **+ \$26 billion** (1998 prices)
- Direct payments of royalty and company tax to 2022: **+ \$6.7 billion** (1998 prices)
- Direct and indirect government revenue increase discounted at the Treasury discount rate of 7% nominal (i.e. some 4% real assuming 3% p.a. inflation): **+ \$9.8 billion\***
- Average employment increase in mature phase 2012 - 2022: **+ 44,000 jobs**

The report also makes the following points:

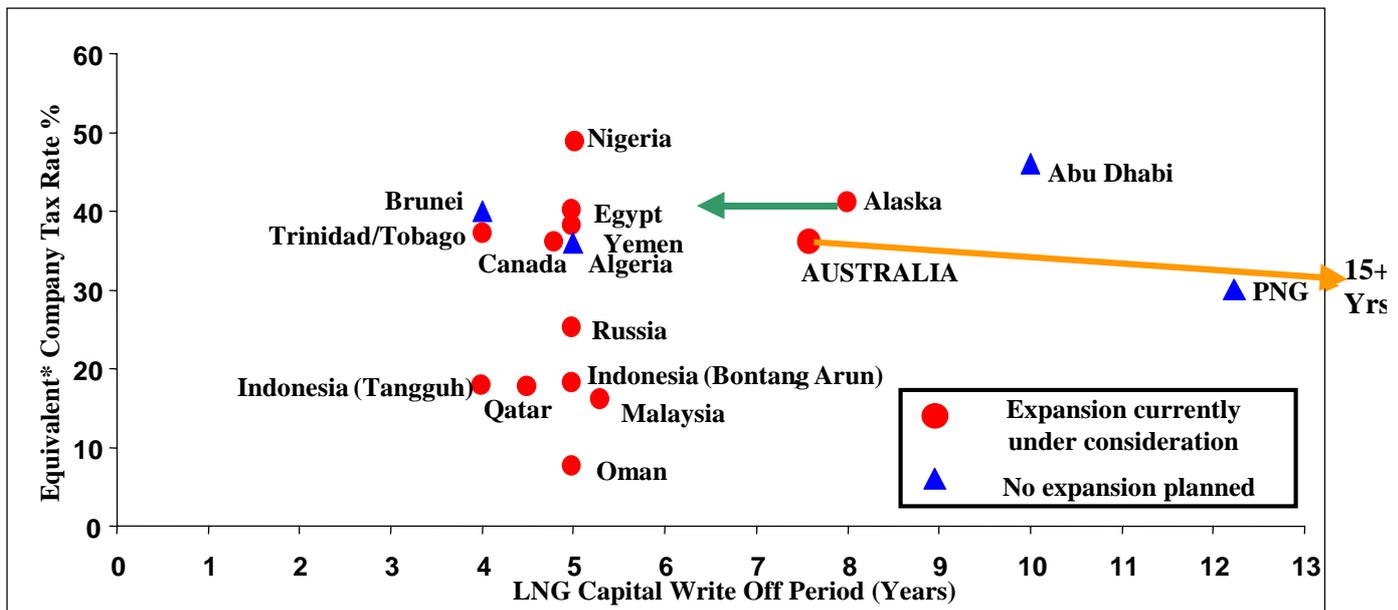
- The project's investment raises aggregate demand, output and employment in the construction phase;
- As exports rise and borrowings are repaid, the project's economic impact grows. Australian incomes rise, private consumption rises as does employment and business investment. Benefits are likely to continue well beyond the assumed end date of the study;
- The project generates large positive net present values in private consumption and government revenue growth compared to the base case of the project not proceeding;
- The expected social returns from the project exceed the private returns.

\* Woodside extrapolation to 2022 based on Access Economics spot calculations to 2013.

## LNG Competitiveness

A key measure of project viability is the after-tax rate of return expected by project owners. This is strongly influenced by both the company tax rate and by the rules governing depreciation of capital. Depreciation rules are especially important for capital intensive long-life projects such as LNG, where construction schedules of 3 - 4 years mean that depreciation deductions cannot commence until several years after expenditure (depreciation not permitted until start-up).

The chart below compares company tax rates and depreciation write-off periods applying to LNG projects currently operating or planned for development. It shows the competitive position of Australia against overseas LNG projects.



The chart shows that most competitors to Australian LNG (Malaysia, Indonesia, Qatar, Oman) enjoy low effective company tax rates and are allowed to depreciate capital over a 4 - 5 year period. In each competitor country, accelerated depreciation is recognised as an important concession to improve the viability of long-life capital intensive projects such as LNG. While Alaska is in the process of renegotiating applicable depreciation schedules for LNG (from 8 year to 5 year write-off), Australia is in danger of degrading its competitive position by lengthening depreciation schedules for LNG.

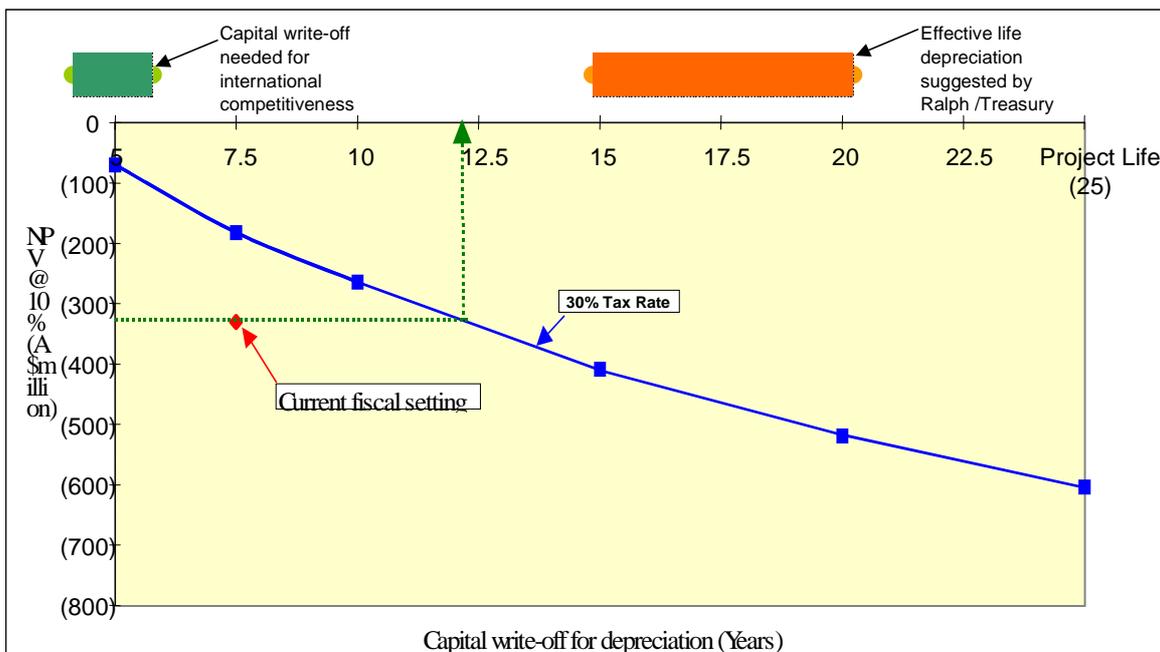
### Impact of effective life depreciation on an LNG project

Our analysis shows that LNG projects are adversely impacted by a move from current depreciation schedules to a 15 - 20 year effective life for depreciation and that a company tax rate of 30% does not fully compensate for the reduction in NPV resulting from effective life depreciation.

The fiscal impediments to expansion of Australia's LNG industry under the current fiscal regime have already been flagged as part of the LNG Action Agenda process. A change to the tax system that achieves no better than NPV neutrality with existing fiscal terms does nothing to improve Australia's competitive position with regard to LNG. LNG projects require internationally competitive company tax rates and depreciation schedules (or equivalent value measures) to stand a chance of meeting the investment hurdle rates required by investors.

The chart below shows that the breakeven depreciation life is some 12 years for a greenfield LNG project<sup>1</sup>. The chart also shows how the project return can be improved by a move to internationally competitive fiscal terms including a 4 - 5 year write-off period for LNG capital (or equivalent value measures).

### Greenfield LNG Project



- Data represents a hypothetical LNG project
- To equalise NPV a 12 year depreciation life is required with a 30% tax rate
- To increase the likelihood of achieving a profitable project, an internationally competitive capital write-off period of ~5 years is required

1. Data depicting "low return LNG project" supplied by APPEA

## Viability of projects - Australian impact

According to Access Economics<sup>2</sup> some \$190 billion of mining and resource-processing investment is forecast for the period 2001 - 2011. Some of this pool of investment will represent projects, which may not proceed if overall taxation conditions deteriorate from those currently available. Our analysis shows that for a range of discount rates, long-life marginal projects are likely to be worse off with effective life depreciation, even with a lower company tax rate of 30%. These projects, although offering marginal returns to investors, will provide substantial community benefits if they proceed.

To estimate the effects of some projects not going ahead if accelerated depreciation is eliminated (i.e. without substitution of equivalent value measures), a hypothetical suite of long-life projects was postulated, based on a typical long-life capital-intensive project such as LNG. The following assumptions were made:

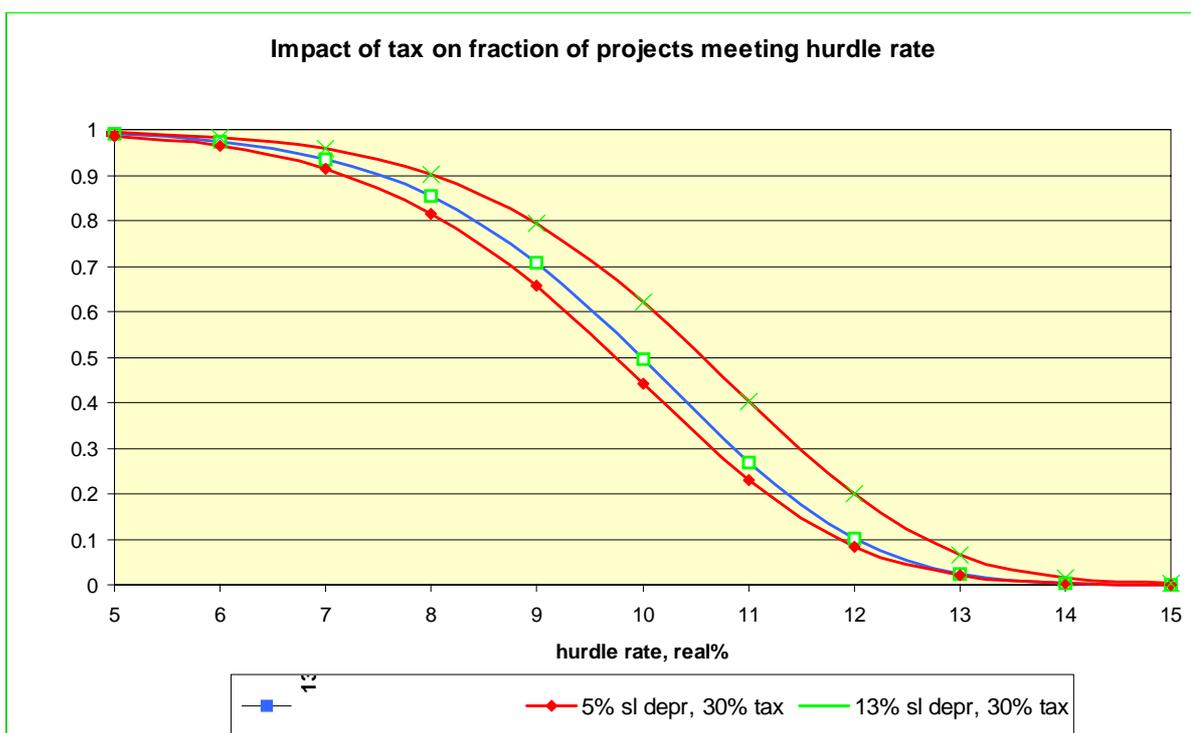
- Project profitability was adjusted by postulating a random (normally distributed) variation to revenue about a mean IRR = 10% real, after tax. This resulted in a portfolio of investments with a range in IRR outcomes of 5% - 14%;
- Current tax treatment of 7.6 year depreciation life and 36% tax rate vs. effective life of 20 years and 30% tax rate;
- Sensitivity to 30% tax rate whilst maintaining existing depreciation schedules.

Results, shown below, indicate that, at a hurdle rate of 10% real, a significant fraction (some 5% or \$10 billion) of the portfolio of long-life investments may well become uneconomic if a 20 year effective life and 30% tax rate replaces current tax treatment. Conversely, a significant fraction (some 10% or \$20 billion) of currently sub-economic projects could become economic if the existing accelerated depreciation regime was maintained in a low tax environment. The chart also shows that similar results are likely to apply over a range of commercially relevant hurdle rates.

The economy-wide benefits of a major investment long-life project going ahead greatly exceed the cost of maintaining accelerated depreciation for that project (\$6.5 billion project, \$400m NPV cost of accelerated depreciation, \$9800 million NPV increase in government revenue). Applying these values to the portfolio of projects means that the "revenue-neutral" trade-off of tax rate with effective life depreciation puts some \$14 billion NPV of Government revenue at risk. Conversely, by maintaining existing depreciation rates in a low tax environment for the entire portfolio of projects at a cost of some \$12 billion NPV, additional government revenue NPV of some \$30 billion could be expected.

2. Access Economics, private communication 12/3/1999, representing forecast investment by industry 2001/02 to 2010/11 in "Mining" and "Resource processing", nominal dollars.

The balance of trade implications of long-life major-investment projects such as LNG also needs careful consideration. With Australia's current account deficit heading towards record highs it is important to consider the implications of discouraging such export oriented investment by removing accelerated depreciation. Other things being equal, an unsustainably high current account deficit reduces national wealth by lowering the exchange rate, putting upward pressure on interest rates thereby dampening economic growth. These threats to economic welfare can be reduced by appropriate policy settings which encourage export industry, namely a lower company tax rate whilst maintaining accelerated depreciation (or introducing equivalent value measures).



### State-by-State economic impact of losing accelerated depreciation

A quick-look study undertaken by Access Economics<sup>3</sup> shows that the costs of losing accelerated depreciation fall disproportionately on WA, Qld and Vic whereas the benefits of a lower company tax rate are more evenly spread amongst the States. While a revenue-neutral outcome may be achieved across Australia, the outcome for states such as WA is far from neutral. Maintaining accelerated depreciation (or introducing equivalent value measures) in a low tax environment could alleviate the adverse impact on WA and on regional Australia.

3. "State Impacts of Proposed Changes to Company Taxation", Access Economics, March 1999

The table below shows the outcome for WA and for Australia if accelerated depreciation is removed in exchange for a 30% company tax rate.

**Table: Annual impacts and net present value calculation (\$million)**

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	NPV
SA	12	193	152	73	68	48	28	21	31	46	87	130	539
ACT	3	57	57	45	50	51	52	56	64	71	79	87	354
NSW	42	658	407	26	-49	-176	-299	-340	-298	-217	-24	172	292
NT	3	43	35	20	19	16	13	13	17	22	31	40	153
TAS	1	22	9	-9	-14	-21	-28	-33	-36	-36	-28	-20	-77
VIC	30	464	256	-45	-115	-224	-329	-378	-368	-322	-177	-29	-341
QLD	17	260	133	-45	-91	-159	-225	-256	-250	-223	-137	-49	-352
<b>WA</b>	<b>12</b>	<b>192</b>	<b>81</b>	<b>-66</b>	<b>-109</b>	<b>-171</b>	<b>-233</b>	<b>-266</b>	<b>-267</b>	<b>-247</b>	<b>-178</b>	<b>-107</b>	<b>-545</b>
<b>AUST</b>	<b>120</b>	<b>1890</b>	<b>1130</b>	<b>0</b>	<b>-240</b>	<b>-635</b>	<b>-1020</b>	<b>-1183</b>	<b>-1106</b>	<b>-906</b>	<b>-348</b>	<b>223</b>	<b>22</b>

*Note - Year refers to year ending June of the year given.*

**Woodside recommends that the competitiveness of Australia's taxation system be improved by lowering the company tax rate to 30% whilst maintaining the current depreciation schedules (or introducing similar value measures) for long-life projects such as LNG. The increased level of investment attracted by an internationally competitive fiscal environment for LNG encompassing a lower company tax rate and attractive depreciation schedules (or equivalent value measures) will generate superior community benefits to an outcome that trades off depreciation schedules against a lower company tax rate.**

- Who should be entitled to deductions?**

The discussion paper notes "the ownership basis for depreciation and other capital allowances has created difficulties and commercial uncertainties". This can be the case for companies in the petroleum exploration and production industry. Situations exist where technically, no tax deduction is available for expenditure incurred on items of plant pursuant to the depreciation provisions because they are owned by another joint venture. In addition, the item may also be located outside the prescribed petroleum operations thereby falling outside the scope of the allowable capital expenditure provisions in Section 330-80 on the Act (ie blackhole expenditure). Within the petroleum industry, there are also certain joint ventures which have entered into unitisation agreements which have complex redetermination clauses to overcome problems where assets are jointly paid for but legally owned by each individual joint venture.

**Woodside supports a change to the current depreciation provisions in accordance with Option 1 that provides for the person who incurs the expenditure on the asset to claim the deduction.**