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Royalty Ruling
Petroleum and Gas (Production and Safety) Act:
DETERMINATION OF PETROLEUM ROYALTY

A royalty ruling, when issued, is the published view of the Commissioner, Office of State Revenue (the Commissioner) on the particular topic to which it relates. It therefore replaces and overrides any existing private rulings, guidelines, memoranda, manuals, advice or similar statements in respect of the issue(s) it addresses. Where a change in legislation or case law (the law) affects the content of a royalty ruling, the change in the law overrides the royalty ruling—that is, the Commissioner will determine the royalty liability in accordance with the changed law.

What this ruling is about

1. The purpose of this royalty ruling is to provide guidance on the calculation of petroleum royalty.
2. The *Petroleum and Gas (Production and Safety) Act 2004* (the Act) requires a petroleum producer (producer) to pay petroleum royalty for petroleum that the producer produces.¹
3. A producer includes:
 - (a) for petroleum produced from a petroleum tenure under the Act or the *Petroleum Act 1923* (the 1923 Act)² (tenure petroleum)—the petroleum tenure holder who produces it, or for whom it is produced
 - (b) for petroleum that is incidental coal seam gas mined under section 318CM of the *Mineral Resources Act 1989* (MR Act)—the coal or oil shale mining lease holder who mines it or for whom it is mined
 - (c) for petroleum that is coal seam gas mined under a mineral hydrocarbon mining lease—the coal or oil shale mining lease holder who mines it or for whom it is mined.³

¹ Section 590(1) of the Act. In certain circumstances, a producer is required to pay petroleum royalty for petroleum that the producer accepts from an overlapping mining lease holder under the *Mineral Resources Act 1989*: see sections 232-233 of the *Mineral and Energy Resources (Common Provisions) Act 2014* (the MER Act) and section 590(1) of the Act as in force before the commencement of the MER Act.

² An authority to prospect or a petroleum lease granted under the relevant Act: section 18(3) of the Act and section 2 of the 1923 Act

³ Schedule 2 of the Act, definition of 'petroleum producer'

4. Under the Petroleum and Gas (Royalty) Regulation 2004 (the Regulation), petroleum royalty is payable for the following royalty return period⁴:
- (a) for tenure petroleum—the return period in which the petroleum is disposed of⁵
 - (b) for any other petroleum (non-tenure petroleum)—the return period in which the petroleum is produced.⁶

Ruling and explanation

Relevant terms

5. A producer *disposes* of petroleum if the producer:
- (a) sells or otherwise transfers ownership of the petroleum to another person
 - (b) flares or vents the petroleum
 - (c) uses the petroleum.⁷
- Disposal* and *disposed of* have corresponding meanings.⁸
6. Petroleum is *produced* when it is:
- (a) recovered to ground level from a natural underground reservoir in which it has been contained
 - (b) released to ground level from a natural underground reservoir from which it is extracted.⁹
- Producing* has a corresponding meaning.¹⁰
7. A *petroleum facility* is a facility for the distillation, processing, refining, storage or transport of petroleum, other than a distribution pipeline.¹¹
8. A *pipeline* is a pipe, or system of pipes, for transporting petroleum or certain other substances, and includes:
- (a) a part of the pipeline
 - (b) a thing connected to or associated with the pipeline that is necessary for its operation.¹²

⁴ See Schedule 2 of the Act, definition of 'royalty return period' and section 146A of the Regulation.

⁵ See paragraph 5 for the meaning of 'disposed of'.

⁶ Section 147(1) of the Regulation

⁷ Section 147(2) of the Regulation

⁸ Section 32 of the *Acts Interpretation Act 1954*

⁹ Section 15 of the Act

¹⁰ Section 32 of the *Acts Interpretation Act 1954*

¹¹ Section 17(1) of the Act. Although section 17(2) of the Act limits this definition by excluding a facility under a petroleum lease or pipeline licence, or a facility under the 1923 Act, for calculating petroleum royalty the term is given its broader meaning in this ruling.

¹² Section 16 of the Act

9. A *relevant well* is a petroleum well in relation to which a producer carries out production testing under:
- section 73 or 152 of the Act¹³
 - a lease or authority to prospect under the 1923 Act (a 1923 Act petroleum tenure).¹⁴
10. The *testing period* in relation to a relevant well is the shorter of:
- the sum of all periods for which production testing from the relevant well is permitted to be carried out, or
 - 13 months from the start of production testing from the relevant well.¹⁵
11. *Testing petroleum* in relation to a relevant well is coal seam gas or natural gas that is produced from the relevant well during the testing period, as part of production testing.
12. In the absence of a legislative definition in the Act or Regulation, in this ruling:
- the following terms have their ordinary meaning¹⁶

Term	Meaning
Distilling	Purifying a liquid by a process of heating and cooling
Plant	A place where an industrial or manufacturing process takes place
Processing	Performing a series of mechanical or chemical operations on something in order to change or preserve it
Refining	Removing impurities or unwanted elements from a substance, typically as part of an industrial process
Storage	The action or method of storing something for future use
Treating	Applying a process or a substance to something to protect or preserve it or to give it particular properties

- given the overlap between the meanings of certain of the terms in paragraph 12(a), for the purpose of this ruling, the term *processing* is taken to encompass *refining*, *treating* and *distilling* and, where connected to these activities, the *storage* of petroleum
- the terms *facility* and *plant* are synonymous.

Coal seam gas

13. Although royalty on coal seam gas mined under a mining lease (ML coal seam gas) is payable under the MR Act, the value is calculated in the same way as for petroleum under the Act.¹⁷ Accordingly, the principles in this ruling apply, with the necessary changes and except where otherwise noted, to the calculation of the value of ML coal seam gas.

¹³ Section 591A(1)(a) of the Act

¹⁴ Section 591A(1)(b) of the Act and Schedule 2 of the Act, definition of '1923 Act petroleum tenure'

¹⁵ Section 591A(3) of the Act

¹⁶ All definitions are from the *Oxford Dictionary of English*, 2012 edition.

¹⁷ Section 53 and Schedule 3, section 7 of the Mineral Resources Regulation 2013 (the MR Regulation)

Petroleum subject to royalty

14. The petroleum royalty payable in relation to a particular petroleum operation for a royalty return period is determined by reference to:
- (a) tenure petroleum sourced from that operation that is disposed of in the royalty return period, irrespective of whether the petroleum was:
 - (i) produced before or during the royalty return period
 - (ii) produced by the producer or by some other person
 - (iii) disposed of by the producer or by some other person
 - (b) non-tenure petroleum sourced from that operation that is produced in the royalty return period, irrespective of whether the petroleum was:
 - (i) produced by the producer or by some other person
 - (ii) disposed of by the producer or by some other person.¹⁸
15. Petroleum royalty must be calculated separately for each petroleum operation for which the producer is liable to pay royalty.
16. Petroleum royalty is payable in relation to all tenure petroleum disposed of during a royalty return period, irrespective of when (or if) the producer receives full or partial payment for the disposals. That is, petroleum royalty is not calculated on a cash receipts basis.
17. For the purposes of calculating petroleum royalty, petroleum that is transferred from one of the producer's petroleum operations to another will be deemed to have been disposed of by the first operation.

Exemptions from petroleum royaltyGeneral exemptions

18. Subject to paragraphs 19 to 21, petroleum is exempt from petroleum royalty if the Minister is satisfied¹⁹:
- (a) the petroleum was unavoidably lost before it could be measured
 - (b) the petroleum is tenure petroleum used in the production of petroleum from the tenure
 - (c) the petroleum is coal seam gas used for mining the coal that produced the gas
 - (d) that, before the petroleum was produced in Queensland, it was produced outside Queensland and injected or reinjected into a natural underground reservoir in Queensland
 - (e) the petroleum is petroleum on which petroleum royalty has already been paid

¹⁸ Section 147(1) of the Regulation

¹⁹ Exemptions for ML coal seam gas are determined under the MR Regulation.

- (f) the petroleum is coal seam gas on which royalty under the MR Act is payable
 - (g) the petroleum was flared or vented as part of testing for the presence of petroleum during the drilling of a well.²⁰
19. Petroleum will cease to be exempt from petroleum royalty (and will therefore be subject to petroleum royalty) where the petroleum becomes the property of the state under Chapter 2, Part 6, Division 3 of the Act.²¹
20. Where the first underground mining of coal in a mining lease commenced before 31 December 2004, petroleum produced on the mining lease and used beneficially for mining under the mining lease is exempt from petroleum royalty.²²
21. Where petroleum referred to in paragraphs 18(c) or 20 is used to generate electricity that is only partly used for mining under the mining lease, the exemption from petroleum royalty applies only to the extent that the electricity is used for that purpose and not some other purpose.²³

Exemptions for ML coal seam gas

22. The exemptions in the Act do not apply for ML coal seam gas because liability in that case is determined under the MR Act.
23. The MR Regulation provides that no royalty is payable for ML coal seam gas that is:
- (a) flared or vented
 - (b) in certain circumstances, used for mining coal.²⁴

Production testing

24. An exemption applies to the first 3,000,000m³ of testing petroleum produced from a particular relevant well that is flared or vented during the testing period for the relevant well.²⁵
25. The exemption does not apply to petroleum that:
- (a) is flared or vented after the testing period for the relevant well, even if:
 - (i) the aggregate amount of testing petroleum flared or vented by the end of the testing period was less than 3,000,000m³
 - (ii) the petroleum was testing petroleum
 - (b) is flared or vented during the testing period for the relevant well, in excess of 3,000,000m³²⁶

²⁰ Section 591(1) of the Act

²¹ Section 591(2) of the Act

²² Section 591(3) of the Act

²³ Section 591(5) of the Act

²⁴ Section 49 of the MR Regulation

²⁵ Section 591A of the Act

²⁶ The 3,000,000m³ limit applies for the testing period, not for each royalty return period that occurs wholly or partly within the testing period.

(c) was not produced as part of production testing, even if the production and/or the flaring or venting occurs during the testing period for the relevant well.

26. Where petroleum is flared or vented and none of the exemptions referred to in paragraphs 18(g), 23(a) or 24 apply, petroleum royalty is payable in relation to the petroleum.

Reporting exempt petroleum

27. Details of the quantity of petroleum subject to an exemption referred to in paragraphs 18 (other than paragraph 18(a)), 20, 23 or 24 must be recorded in the royalty return for the relevant return period, even though no petroleum royalty is payable in relation to the petroleum. However, it is not necessary for the producer to determine the value of the petroleum.

Royalty rate

28. Petroleum royalty in respect of a particular operation is payable at the rate of 12.5%²⁷ of the wellhead value of the tenure petroleum disposed of, or non-tenure petroleum produced, during a royalty return period from the operation.²⁸

Wellhead value

Calculation

29. The wellhead value of petroleum is calculated²⁹ by:

(a) determining the amount that the petroleum could reasonably be expected to realise if it were sold on a commercial basis (commercial amount)³⁰, and

(b) subtracting:

(i) certain expenses for the royalty return period (permitted expenses)³¹

(ii) any applicable negative wellhead value.³²

30. Where a component³³ of the wellhead value is the subject of a petroleum royalty decision³⁴, the wellhead value of the petroleum must be calculated with reference to the amount of the component stated in the petroleum royalty decision, rather than any amount actually received, paid or payable (as the case may be) by the producer.³⁵

²⁷ A royalty rate of 11.25% applies for annual royalty returns lodged for the return period ending 31 December 2019 (other than returns lodged under section 599(8) of the Act): section 1006 of the Act.

²⁸ Section 147C of the Regulation

²⁹ Section 148(2) of the Regulation

³⁰ Section 148(2)(a) of the Regulation

³¹ Section 148(2)(b)(i) and (3) of the Regulation

³² Section 148(2)(b)(ii) and (5) of the Regulation

³³ An element used to work out the commercial amount or a permitted expense (or an amount contributing to a permitted expense): section 148A of the Regulation

³⁴ See Chapter 6, Part 2, Subdivision 2 of the Regulation in relation to petroleum royalty decisions.

³⁵ Section 148(7) of the Regulation.

31. All calculations involving the conversion of foreign currency into Australian dollars for a particular royalty return period should use an exchange rate for the appropriate date³⁶ obtained from a consistent, reasonable external source. Examples of an exchange rate that is considered reasonable include:
- (a) the WM/Reuters Australian Fix 10.00am or 4.00pm rate
 - (b) a rate published by a major Australian commercial bank or financial institution
 - (c) an exchange rate referred to in Schedule 2 of the Income Tax Assessment Regulations 1997 (Cwlth), subject to:
 - (i) any limitations contained in that Schedule in relation to the calculation or use of such exchange rate
 - (ii) the period selected for calculation of an average exchange rate being no longer than the royalty return period.
32. The wellhead value of petroleum must be calculated exclusive of the goods and services tax (GST)—that is, reflecting the net revenue or expense for each component of the wellhead value).
33. The wellhead value of petroleum must be calculated separately for each petroleum operation for which the producer is liable to pay royalty.

Permitted expenses generally

34. Broadly, the permitted expenses that may be deducted by a producer when calculating the wellhead value of petroleum are:
- (a) a pipeline tariff or other charge for transporting the producer's petroleum through a pipeline to the point of its disposal (tariff)
 - (b) a processing plant toll or other charge for processing the producer's petroleum before it is disposed of (toll)
 - (c) depreciation of capital expenditure on a petroleum facility or pipeline used for processing the producer's petroleum or transporting it from the wellhead of the well in which it was produced to the point of its disposal
 - (d) an operating cost that directly relates to a particular prescribed activity (direct operating cost)
 - (e) an expense approved by the Minister (approved expense).³⁷

³⁶ For revenue, the appropriate date is the date of receipt of payment (irrespective of the date on which such amounts are converted into Australian dollars (if at all)). For expenses, the appropriate date is the date of payment. However, where revenue has not been received, or payment of an expense has not been made, by the time that the royalty return for the royalty return period is lodged, the appropriate date is the date of issue of the invoice (for revenue) or the date of receipt of the invoice (for expenses).

³⁷ Section 148(3) of the Regulation

35. For calculating petroleum royalty, the wellhead value of petroleum is determined by applying the formula prescribed by the Regulation, which states the specific deductions that are allowed to be claimed for royalty purposes. It does not take into account all expenses incurred by a producer in relation to a particular operation, general corporate or overhead costs of the producer (e.g. income tax) or land-related costs.
36. Permitted expenses must be determined separately for each petroleum operation for which the producer is liable to pay royalty. Where a producer incurs an expense that relates to multiple operations (such as repairs and maintenance in relation to a pipeline that transports petroleum from 2 or more separate operations), the expense must be apportioned between the operations on a fair and reasonable basis. What constitutes a fair and reasonable basis will vary depending on, among other things, the nature of the expense and the manner in which it is incurred.

Example 1

XYZ Pty Ltd (XYZ) holds petroleum tenures under the Act and is a producer.

XYZ owns a processing facility, which processes petroleum from 2 of XYZ's operations: the Alpha operation and the Bravo operation.

On 1 September 2016, XYZ engages JKL Pty Ltd (JKL), an unrelated party, to perform routine maintenance work on the facility. JKL completes that work on 8 September 2016, and receives final payment of \$50,000 from XYZ on 15 September 2016.

During the royalty return period ended 30 September 2016, a total of 10,000 GJ of gas is processed through the facility—7,000 GJ from the Alpha operation, and 3,000 GJ from the Bravo operation.

It would be reasonable to allocate the cost of the maintenance work between the Alpha and Bravo operations with reference to their relative use of the facility during the royalty return period (i.e. 70% by Alpha and 30% by Bravo). Accordingly, in the royalty returns for that period, XYZ claims a deduction of:

- \$35,000 (i.e. \$50,000 × 70%) in relation to the Alpha operation
- \$15,000 (i.e. \$50,000 × 30%) in relation to the Bravo operation.

37. The substance of an expense, rather than the description given to it by the producer and/or any other person, will determine whether the expense is a permitted expense. In some cases, this may require examination of documentation between the producer and the supplier of the relevant good or service (such as contracts, purchase orders and invoices) to determine the nature of the good or service supplied.
38. A producer must keep all records necessary to enable the petroleum royalty payable by the producer to be calculated.³⁸ This includes appropriate records to justify an apportionment of expenses between multiple operations and/or between deductible and non-deductible purposes.

Timing of permitted expenses

39. Subject to meeting all other requirements:

- (a) a deduction for a tariff or a toll can only be claimed if the expense has been *paid* or is *payable*

³⁸ Chapter 6, Part 3A of the Act

- (b) a deduction for a direct operating cost can only be claimed if the expense is *incurred* or *to be incurred*.

40. For these purposes:

- (a) 'paid' means that the expense has been paid
- (b) 'payable' means that there is a presently existing liability to pay the expense, even if payment is not due until a future date (e.g. the producer has received an invoice from a service provider, which is payable 30 days after the date of issue)
- (c) 'incurred' means that the expense is paid or payable (as those terms are defined in paragraph 40(a) and (b) respectively)
- (d) 'to be incurred' means that, although the liability to pay the expense does not presently exist (i.e. it is not payable as that term is defined in paragraph 40(b)):
 - (i) the good or service for which the expense is payment has been provided to, or received by, the producer under an arrangement where a liability to pay the expense is certain to exist at a future time
 - (ii) the expense can be quantified with certainty.

Example 2

UVW Pty Ltd (UVW) provides periodic maintenance services to a pipeline owned by XYZ, at a flat rate of \$200 per hour (excluding GST). Under the contract between the parties, XYZ has no liability to pay for particular services provided by Uvw until Uvw renders an invoice.

On 29 June 2016, XYZ requests Uvw to provide 3 hours of maintenance services. Uvw provides the services on 30 June 2016. An invoice for those services is not issued by Uvw until 14 July 2016 (i.e. the next royalty return period).

When calculating petroleum royalty for the royalty return period ended 30 June 2016, XYZ can claim a deduction for \$600, on the basis that the maintenance expense is to be incurred (the maintenance services have been performed and the liability can be quantified).

Example 3

Same facts as Example 2, but Uvw does not provide the services until 1 July 2016.

Because the service is not provided in the royalty return period ended 30 June 2016, XYZ cannot claim a deduction for the maintenance expense for that quarter (even though the amount of the expense can be determined). The expense can be claimed as a deduction for the royalty return period ended 30 September 2016.

41. Where, in a particular royalty return period, a direct operating cost is to be incurred, or a tariff, toll or direct operating cost is payable (as defined in paragraph 40), a producer may claim the expense as a deduction in either:
- (a) that royalty return period, or
 - (b) the royalty return period in which the expense is incurred (in the case of a direct operating cost) or is paid.

However, where a particular expense has been claimed as a deduction in one royalty return period, that expense may not be claimed again in a subsequent period on a different basis.

Example 4

Same facts as Example 2

Having claimed a deduction for the royalty return period ended 30 June 2016, XYZ may not claim another deduction for the maintenance expense for the royalty return period ended 30 September 2016 (being the period during which the expense is incurred).

42. Only expenses paid, payable, incurred or to be incurred (as the case may be) by the producer in relation to the producer's petroleum are deductible.

Example 5

ABC Pty Ltd (ABC) is the parent company of XYZ, and is also a producer.

ABC enters into an arrangement with an unrelated party, DEF Pty Ltd (DEF) to transport XYZ's petroleum from a processing facility to the point of its disposal. Under that arrangement, ABC pays a pipeline tariff to DEF.

ABC and XYZ are part of the same corporate group, so ABC elects not to on-charge or otherwise recover an amount from XYZ on account of ABC's payment of the tariff.

Because the tariff was neither paid nor payable by XYZ, XYZ cannot claim a deduction for the expense when calculating the wellhead value of its petroleum.

Although the tariff was paid by ABC, the tariff was not in relation to ABC's petroleum. Accordingly, ABC cannot claim a deduction for the expense when calculating the wellhead value of its petroleum.

Tariffs

43. An expense may be deducted as a tariff where all of the following conditions are satisfied:
- (a) an amount (whether described as a pipeline tariff or not) is paid or payable by the producer to a third party:
 - (i) who is the owner or operator of a pipeline, or
 - (ii) who in turn pays an amount to the owner or operator of a pipeline (e.g. a logistics company)
 - (b) the amount is for:
 - (i) the transportation of the producer's petroleum through the pipeline to the point of its disposal (including any payment for transportation entitlements under a take-or-pay access agreement that are not used by the producer and for which the producer does not receive monetary or non-monetary consideration from any other person), or
 - (ii) the third party to procure such transportation, at the third party's expense (i.e. the producer does not directly pay the owner or operator of the pipeline)
 - (c) the Minister reasonably believes that the amount is reasonable on a commercial basis.³⁹

³⁹ Section 148(3)(a) of the Regulation

44. Where petroleum is transported through a pipeline wholly owned by the producer, the producer cannot claim a deduction for a notional tariff. In such a case, a deduction may potentially be available for depreciation of the pipeline and/or for a direct operating cost.⁴⁰ Similarly, where a pipeline is partially owned by the producer, the particular charging arrangements must be examined to determine the extent to which any amount paid by the producer may be deductible as a tariff.
45. Where petroleum is transported through two or more consecutive pipelines from the wellhead to the point of disposal, a tariff paid or payable in relation to each of those pipelines may be deducted (subject to meeting all other relevant criteria).

Example 6

Before it is disposed of, XYZ's petroleum is transported through two pipelines. The first pipeline, owned by GHI Pty Ltd (GHI), transports XYZ's petroleum from the wellhead to a processing facility. A separate pipeline, owned by DEF, transports XYZ's petroleum from the outlet of the processing facility to the point of its disposal. XYZ pays a reasonable commercial tariff to both DEF and GHI.

Although GHI's pipeline does not deliver petroleum directly to the point of disposal, the petroleum flows through that pipeline en route to its point of disposal. Accordingly, XYZ can claim a deduction for the tariff paid to GHI.

XYZ can also claim a deduction for the tariff paid to DEF.

46. Amounts paid or payable by a producer in relation to the following are not deductible as a tariff:
- (a) the transportation by pipeline of something other than petroleum (e.g. produced water⁴¹)
 - (b) the transportation of petroleum other than by pipeline (e.g. by tanker).

Such an expense would only be deductible if it was a direct operating cost.⁴²

47. The Minister may determine what is a reasonable tariff on a commercial basis in the particular circumstances.

Tolls

48. An expense may be deducted as a toll where all of the following conditions are satisfied:
- (a) an amount (whether or not described as a processing plant toll) is paid or payable by the producer to a third party:
 - (i) who is the owner or operator of a plant for processing petroleum⁴³, or
 - (ii) who in turn pays an amount to the owner or operator of a petroleum processing plant (e.g. a logistics company)
 - (b) the amount is for:
 - (i) the processing of the producer's petroleum prior to disposal (including any payment for processing entitlements under a take-or-pay access agreement that are not used

⁴⁰ See discussion commencing at paragraph 51 in respect of direct operating costs.

⁴¹ See definition in s.15A of the Act.

⁴² See discussion commencing at paragraph 51.

⁴³ See paragraph 12(b).

by the producer and for which the producer does not receive monetary or non-monetary consideration from any other person), or

- (ii) the third party to procure such processing, at the third party's expense (i.e. the producer does not directly pay the owner or operator of the plant)
- (c) the amount is calculated:
 - (i) on a commercial basis, or
 - (ii) another basis that the Minister reasonably believes is the most practicable, given the use of the plant by other producers or for other purposes.⁴⁴

49. Where petroleum is processed in a plant wholly owned by the producer, the producer cannot claim a deduction for a notional toll. In such a case, a deduction may potentially be available for depreciation of the plant and/or for a direct operating cost.⁴⁵ Similarly, where a plant is partially owned by the producer, the particular charging arrangements must be examined to determine the extent to which any amount paid by the producer may be deductible as a toll.

50. Amounts paid or payable by a producer in relation to the processing of something other than petroleum (e.g. produced water) are not deductible as a toll.

Direct operating costs

Requirements for deductibility

51. An expense may be deducted as a direct operating cost where all of the following conditions are satisfied⁴⁶:
- (a) the expense is incurred, or is to be incurred, by the producer, as opposed to by another person
 - (b) the expense is an operating cost, as opposed to a capital cost
 - (c) the expense directly relates to a relevant activity (as defined below⁴⁷), as opposed to:
 - (i) indirectly relating, or not relating at all, to a relevant activity
 - (ii) relating (directly or indirectly) to something other than a relevant activity
 - (d) the expense is not deductible as a tariff or toll
 - (e) the expense is not an excluded expense.⁴⁸

⁴⁴ Section 148(3)(b) of the Regulation

⁴⁵ See discussion commencing at paragraph 51 in respect of direct operating costs.

⁴⁶ Section 148(3)(d) of the Regulation

⁴⁷ See paragraph 52.

⁴⁸ See paragraph 72.

Relevant activity

52. Under the Regulation, only costs directly related to the following activities (each, a relevant activity) are potentially deductible:
- (a) treating, processing or refining of the producer's petroleum before it is disposed of⁴⁹
 - (b) transporting the producer's petroleum to the point of its disposal.⁵⁰
53. The requirement for a cost to have a nexus to a relevant activity means that not all operating costs incurred by a producer (either generally, or in relation to the producer's petroleum up to the point of disposal) are deductible when calculating wellhead value. Further, the Regulation specifically excludes certain operating costs incurred by the producer from being deductible.⁵¹
54. The treating, processing, refining or transporting of something other than the producer's petroleum (e.g. produced water) is not a relevant activity.

'Directly relates to'

55. The phrase 'directly relates to' takes its ordinary meaning. 'Directly' means 'without an intermediary; by a direct process'⁵² or 'with nothing or no one in between'⁵³; and 'relates to' means 'have some connection with, be connected'⁵⁴ or 'have reference to; concern'.⁵⁵
56. To be 'directly related', there must be a 'sufficiently close connection'⁵⁶ between an expense and a relevant activity. The relevant activity must be the proximate cause of the payment, and no direct relationship will exist where the relevant activity is 'a cause less proximate, or ... only one contributory cause'.⁵⁷
57. An expense is not directly related to a relevant activity simply because it is not directly related to something other than a relevant activity. Put differently, a producer may incur expenses that will not be directly related to any one particular thing, but are merely indirectly related to one or more things (for example, general overhead costs for a head office).
58. An expense will not necessarily directly relate to an activity simply because:
- (a) the activity could not have been performed without the expense being incurred⁵⁸
 - (b) the good or service to which the expense relates facilitated the performance of the activity⁵⁹

⁴⁹ See paragraph 12(b).

⁵⁰ Section 148(3)(d) of the Regulation

⁵¹ See paragraph 72.

⁵² *Shorter Oxford English Dictionary*, Oxford University Press 2007

⁵³ *Oxford Dictionary of English*, Oxford University Press 2012

⁵⁴ *Shorter Oxford English Dictionary*, Oxford University Press 2007

⁵⁵ *Oxford Dictionary of English*, Oxford University Press 2012

⁵⁶ *Commissioner of Taxation v. Faywin Investments* (1990) 93 ALR 241 at 253, per Bowen CJ and French J

⁵⁷ *Federal Commissioner of Taxation v. Dixon* (1952) 86 CLR 540 per Dixon CJ and Williams J at 553-4

⁵⁸ *Auckland Regional Authority v. Commissioner of Inland Revenue* (1994) 16 NZTC 11,080, where charges in relation to the use of airline terminals were held to be ancillary to, and not 'directly in connection with', airline transportation

⁵⁹ *Malololailai Interval Holidays NZ Ltd v. Commissioner of Inland Revenue* (1997) 18 NZTC 13,137, where it was held that a contract entered into between a holidaymaker and the owner of a holiday property was 'directly in connection

(c) the expense arises as a consequence of a relevant activity being performed.

For example, for section 148(3)(d) of the Regulation, petroleum tenure rent is considered to be an operating expense that does not directly relate to a relevant activity, even though failure to pay rent may prevent a producer applying for renewal of a petroleum lease⁶⁰ on which a relevant activity is conducted.⁶¹

59. Similarly, the practical or legislative necessity of particular expenditure does not affect whether the expenditure is a direct operating cost. For example, although a producer is required to enter into a conduct and compensation agreement in order to legally enter private land to carry out certain activities⁶², landholder compensation paid under the agreement is not considered to be an operating expense that directly relates to a relevant activity.
60. The deductibility of the expense for income tax purposes is not relevant to determining whether the expense has the requisite nexus with a relevant activity for royalty purposes.
61. The attachment to this ruling sets out a list of common operating costs incurred by producers in conducting an operation, and identifies those that may potentially directly relate to a relevant activity and those that do not directly relate to a relevant activity.
62. Where a producer uses its own petroleum, a deduction equal to the value of that petroleum may only be claimed to the extent that the use directly relates to a relevant activity.

Apportionment

63. Where a particular expense directly relates to a relevant activity only in part, the expense must be apportioned on a fair and reasonable basis. What constitutes a fair and reasonable basis will depend upon, among other things, the nature of the particular expense and the manner in which it is incurred.

Example 7

One of XYZ's staff members performs a variety of tasks for the company. On average, the staff member spends 3 days in each 5-day work week performing maintenance on pipelines and processing facilities owned by XYZ, and the remaining 2 days performing maintenance in relation to XYZ's production assets. The staff member is paid \$30,000 per royalty return period.

Because 60% of the staff member's work time is spent on activities directly relating to a relevant activity, in calculating wellhead value for the royalty return period, XYZ can claim a deduction of \$18,000 (i.e. 60% of \$30,000) for the staff member's wages.

64. Consistent with long-standing practice, the Commissioner considers that 10% of the costs associated with nodal compression or first stage compression in natural gas and coal seam gas production operations are not deductible, on the basis that such compression contains a petroleum extraction component.

with' the property, but the provision of marketing services by another entity that led up to such contract did not have such a connection

⁶⁰ Section 161(1)(a) of the Act

⁶¹ See paragraph 66 in relation to the deductibility of petroleum tenure rent.

⁶² Section 500 of the Act

Approved expenses

65. The Minister may approve a deduction for an expense incurred, or to be incurred, by a producer in relation to the operation of the site at which the producer's petroleum was produced.⁶³
66. As at the date of this ruling, the only expenses approved by the Minister are:
- (a) annual rent payable under the Act or the 1923 Act in respect of a petroleum tenure for the operation
 - (b) office overhead costs, to the extent that the functions performed in the office relate to a relevant activity and the office is located:
 - (i) for tenure petroleum—within the area of the tenure
 - (ii) for non-tenure petroleum—at the site at which the petroleum is produced.

Negative wellhead value

67. Where the total of the permitted expenses for a particular operation for a particular royalty return period exceeds the amount that the petroleum could reasonably be expected to realise if it were sold on a commercial basis, the amount of the excess is a negative wellhead value for the period.
68. A negative wellhead value for a particular royalty return period may be deducted when calculating the wellhead value of petroleum in a later royalty return period:
- (a) within the same annual return period
 - (b) for the same operation.⁶⁴
69. Where a negative wellhead value arises in the final royalty return period in the annual return period for an operation, the negative wellhead value may not be deducted when calculating the wellhead value of petroleum:
- (a) in a subsequent royalty return period for the same operation
 - (b) for any other operation conducted by the producer or another person.
70. As noted, negative wellhead value can only be used to reduce the producer's liability for petroleum royalty in relation to the relevant operation.
71. A producer is not entitled to receive any payment from the state in relation to a negative wellhead value.⁶⁵

⁶³ Section 148(3)(e) of the Regulation

⁶⁴ Section 148(5) of the Regulation

⁶⁵ Section 148(6) of the Regulation

Excluded expensesExcluded expenses generally

72. The following expenses (excluded expenses) are not deductible when calculating wellhead value:
- (a) an expense incurred by the producer in producing petroleum, including, for example, lifting costs (production costs)
 - (b) office overhead costs for an office that is not located within the area of the tenure (for tenure petroleum) or the site at which petroleum is produced (for non-tenure petroleum)
 - (c) marketing costs in relation to the sale of petroleum
 - (d) Commonwealth excise levies
 - (e) a civil penalty or royalty penalty amount, or interest on an amount, payable by the producer under the Act.⁶⁶

Production costs

73. Production costs include:
- (a) costs in relation to workovers⁶⁷
 - (b) repairs and maintenance costs in relation to production assets such as the following:
 - (i) beam pumps
 - (ii) electrical submersible pumps
 - (iii) jet pumps
 - (iv) other wellhead pumps
 - (v) telemetry associated with the wellhead
 - (vi) water pumps associated with coal seam gas wells.

⁶⁶ Section 148(4) of the Regulation

⁶⁷ A workover is a process where a suspended or completed petroleum well is re-entered using a drilling rig, wireline or other means to clean, maintain, repair or treat the well (including re-perforation), or to change the downhole configuration of the well (including deepening and sidetracking) in order to maintain or enhance well functions.

Date of effect

74. Subject to paragraphs 75 and 76, this royalty ruling reflects the Commissioner's existing interpretation and practices as at the date of issue.
75. Where there is inconsistency between Ministerial Statement 68—*Clarification of revenues and allowable deductions in establishing wellhead value under section 148 of the Petroleum and Gas (Production and Safety) Regulation 2004* (MIN 68) and this royalty ruling (so far as this ruling relates to a period prior to 11 January 2016), MIN 68 will prevail to the extent of the inconsistency.
76. The interpretation and practices contained in the following paragraphs (and associated footnotes) have effect in relation to tenure petroleum disposed of, or non-tenure petroleum produced, on or after 11 January 2016:
- (a) for tenure petroleum disposed of by being used in the production of petroleum from the tenure:
 - (i) paragraph 27, to the extent that it does not require the producer to determine the value of the petroleum
 - (ii) paragraph 51(e), to the extent that it prevents the cost of the petroleum being deducted as a direct operating cost⁶⁸
 - (b) paragraphs 58 and 66(a), to the extent that they provide for the basis on which annual rent is deductible
 - (c) paragraph 66(b), to the extent that it provides for the basis on which certain office overhead costs are deductible.
77. MIN 68 has been withdrawn with effect from 10 January 2016.

Elizabeth Goli
 Commissioner, Office of State Revenue
 Date of issue: 1 July 2019

References

Royalty Ruling	Issued	Dates of effect	
		From	To
Royalty Ruling PGA001.2	1 July 2019	1 July 2019	30 September 2020
Royalty Ruling PGA001.1	11 January 2016	11 January 2016	30 June 2019

⁶⁸ MIN 68 implies that a value should be determined for such petroleum, and a corresponding deduction claimed to negate any royalty applicable to such petroleum.

Attachment

Examples of deductible and non-deductible operating costs

The following table contains examples⁶⁹ of:

- (a) potentially deductible expenses, which, in appropriate circumstances:
- (i) may be directly related to a relevant activity and therefore deductible as a direct operating cost, or
 - (ii) have been authorised by the Minister as being deductible (marked with an asterisk *)
- (b) non-deductible expenses, which:
- (i) are not considered to be directly related to a relevant activity, or
 - (ii) are excluded expenses.

These expenses are therefore not deductible.

Potentially deductible expenses	Non-deductible expenses
<i>Activity-related costs</i>	
Processing costs for separation of petroleum from water	Processing or treatment costs in relation to something other than petroleum (e.g. produced water)
Operating costs of a building, to the extent it is used directly in a relevant activity	Operating costs of a building, to the extent it is not used directly in a relevant activity (e.g. workshops)
Operating costs of equipment, to the extent it is used directly in a relevant activity	Operating costs of equipment, to the extent it is not used directly in a relevant activity (e.g. lifting equipment, injection units and hoists)
Operating costs of a vehicle, to the extent it is used directly in a relevant activity (e.g. fuel, lubricant, parts, repairs and maintenance, and registration fees)	Operating costs of a vehicle, to the extent it is not used directly in a relevant activity
Cleaning costs of an asset, to the extent it is used directly in a relevant activity	Cleaning costs of an asset, to the extent it is not used directly in a relevant activity
Costs associated with transporting petroleum from the wellhead to the point of its disposal, including: <ul style="list-style-type: none"> • a reasonable portion of road maintenance and repairs • repairs and maintenance of pipelines • motor vehicle operating costs • wharfage fees and harbour dues 	Costs associated with transportation of something other than petroleum (e.g. produced water)

⁶⁹ The table is not intended to be exhaustive.

Potentially deductible expenses	Non-deductible expenses
Costs of storage of: <ul style="list-style-type: none"> • produced petroleum • consumables, to the extent they are used directly in a relevant activity 	Costs of storage of something other than: <ul style="list-style-type: none"> • produced petroleum • consumables, to the extent they are used directly in a relevant activity (e.g. produced water)
Costs of electricity/power generation, to the extent that the electricity/power is used directly in a relevant activity	Costs of electricity/power generation, to the extent that the electricity/power is not used directly in a relevant activity
Costs of consumables, to the extent they are used directly in a relevant activity	Costs of consumables, to the extent they are not used directly in a relevant activity
Communications costs, to the extent the communications directly relate to a relevant activity (e.g. two-way radios used by staff monitoring a pipeline)	Communications costs, to the extent the communications do not directly relate to a relevant activity (e.g. mobile telephones used by head-office staff)
Costs of removal of waste, to the extent that such waste constitutes petroleum as defined in the Act (petroleum waste), other than marketing costs where the producer receives payment for such waste	Costs of removal of waste other than petroleum waste (e.g. general waste, contaminated water and industrial waste)
	Costs of documentation, review or audit of procedures, whether or not in relation to relevant activities
	Site security costs (e.g. fences, locks, signs, labour)
	Costs of environmental management, whether or not in relation to a relevant activity
	Costs of maintenance of a site on which a relevant activity is conducted, including control of weeds and other vegetation, pest control, minor civil works
<i>Asset-related costs</i>	
Insurance costs in relation to an asset, to the extent that it is used directly in a relevant activity	Insurance costs in relation to an asset, to the extent that it is not used directly in a relevant activity
Repairs and maintenance costs of an asset, to the extent that it is used directly in a relevant activity	Repairs and maintenance costs of an asset, to the extent that it is not used directly in a relevant activity
Operating costs in relation to computer hardware and software used directly in a relevant activity (e.g. computer to control plant temperature)	Operating costs in relation to computer hardware and software not used directly in a relevant activity (e.g. computer used in head office to prepare royalty returns)

Potentially deductible expenses	Non-deductible expenses
	End-of-life costs of any assets (e.g. decommissioning studies), whether or not such assets are used directly in a relevant activity
<i>Personnel costs</i>	
<p>The following costs in relation to personnel, to the extent that the person is engaged directly in a relevant activity:</p> <ul style="list-style-type: none"> • wages and salaries • travel costs to and from the production site • payments made to a contractor under a contract for services, to the extent that such payments relate to the provision of labour or skills • on-costs in relation to the supply of labour and skills (e.g. payroll tax, superannuation, WorkCover and fringe benefits tax) 	<p>The following costs in relation to personnel, to the extent that the person is not engaged directly in a relevant activity:</p> <ul style="list-style-type: none"> • wages and salaries • travel costs to and from the production site • payments made to a contractor under a contract for services, to the extent that such payments relate to the provision of labour or skills • on-costs in relation to the supply of labour and skills (e.g. payroll tax, superannuation, WorkCover and fringe benefits tax) <p>A person is not engaged directly in a relevant activity to the extent that the person performs administrative functions (on-site or off-site) such as:</p> <ul style="list-style-type: none"> • human resources • tenure administration • finance/accounting • training • information technology • information management • landowner liaison • community liaison • cultural heritage
Basic accommodation and catering costs for personnel, to the extent that the person is engaged directly in a relevant activity	Basic accommodation and catering costs for personnel, to the extent that the person is not engaged directly in a relevant activity
Training costs, to the extent the training relates directly to a relevant activity (e.g. training on use of processing equipment)	Training costs, to the extent the training does not relate directly to a relevant activity (e.g. training on human resources, staff development, workplace health and safety, or environmental safety)

Potentially deductible expenses	Non-deductible expenses
General health, safety and medical expenses, to the extent they relate directly to personnel who are engaged directly in a relevant activity	General health, safety and medical expenses to the extent they do not relate directly to personnel who are engaged directly in a relevant activity
Costs of uniforms for personnel, to the extent that the person is engaged directly in a relevant activity	Costs of uniforms for personnel, to the extent that the person is not engaged directly in a relevant activity
	Entertainment costs for personnel, whether or not they are engaged directly in a relevant activity (e.g. pay TV, sports equipment, games, Christmas parties, alcoholic beverages)
	Recruitment and pre-employment costs (e.g. medical examinations and relocation expenses)
	Costs of fitness equipment or gym memberships, whether or not they are used by personnel who are engaged directly in a relevant activity
<i>General costs</i>	
Annual rents payable under the Act or the 1923 Act in respect of a petroleum tenure for the operation*	Any other land or tenure-based payments (e.g. council rates, landholder compensation)
Office overhead costs, to the extent that the functions performed in the office relate to a relevant activity and the office is located: <ul style="list-style-type: none"> • for tenure petroleum—within the area of the tenure • for non-tenure petroleum—at the site at which the petroleum is produced* 	Office overhead costs, to the extent that the functions performed in the office do not relate to a relevant activity and the office is located: <ul style="list-style-type: none"> • for tenure petroleum—within the area of the tenure • for non-tenure petroleum—at the site at which the petroleum is produced
	Fire safety and control expenses
	Most government taxes, excise, levies, fees and charges (e.g. GST, state taxes, royalties, fees payable to the Department of Environment and Heritage Protection or the Department of Natural Resources and Mines, council charges, water commission levy, customs duty)
	Bank and credit card fees and charges
	Gratuities (e.g. donations, awards, entertainment and gifts)
	Subscriptions, publications and memberships

Potentially deductible expenses	Non-deductible expenses
<i>Excluded expenses</i>	
	Expenses incurred in producing petroleum (e.g. lifting costs including artificial lift, biocide, chemical injection, 10% of first stage compression)
	Office overhead costs for an office that is not located: <ul style="list-style-type: none"> • for tenure petroleum—within the area of the tenure • for non-tenure petroleum—at the site at which the petroleum is produced
	Marketing costs in relation to the sale of the petroleum
	Commonwealth excise levies
	A civil penalty or royalty penalty amount, or interest on an amount, payable by the producer under the Act