October 2012

New Zealand submission under the APEC fossil fuel subsidy reform voluntary reporting mechanism

Introduction

*APEC objectives for the fossil fuel subsidy reform (**FFSR**) voluntary reporting mechanism (**VRM**)*

1 Completion of this annual voluntary report is intended to assist APEC members in:

a. assessing and reporting inefficient fossil fuel subsidies that currently exist in their economies;

b. sharing lessons learned regarding reform of inefficient fossil fuel subsidies; and

c. building toward best practices in this area.

Objectives for early stages of international FFSR from New Zealand's perspective: transparency, promoting ambition for reform, and supporting reform efforts

2 For the purposes of this submission, New Zealand draws a distinction between:

a. fossil fuel support measures, which may or may not be inefficient; and

b. inefficient fossil fuel subsidies, which the APEC reform process aims to address.

3 Only with a full picture of fossil fuel support measures and interactions of policies can analysis be undertaken to determine which policies may have inefficient or environmentally harmful effects, and which measures are most harmful.

4 From New Zealand's perspective, the objectives for these early stages of the international FFSR effort are to:

a. promote transparency around present fossil fuel *support measures* more broadly (including subsidies), and draw lessons from past reforms of fossil fuel *subsidies*;

b. promote ambition for reform of inefficient fossil fuel subsidies by maintaining a free and frank dialogue; and

c. build political awareness of the issues around reform.

5 The sharing of experiences of past reforms is important. Experiences of past reforms in APEC economies provide useful lessons that will lead to best practice and increase the likelihood of successful reform in other economies. By sharing lessons of past and ongoing reforms, areas that economies require support can be identified and capacity building support can be suitably targeted.

Definition of "inefficient fossil fuel subsidy that encourages wasteful consumption"

6 APEC has not yet undertaken any work to define "*inefficient fossil fuel subsidy that encourages wasteful consumption*". New Zealand's view is that, at this early stage of the reform process, it is more useful to obtain a better understanding of the full range of fossil fuel support measures that exist and their policy objectives, to help clarify what might constitute an "*inefficient fossil fuel subsidy that encourages wasteful consumption*".

7 New Zealand does not consider that it currently has any "*inefficient fossil fuel subsidies that encourage wasteful consumption*".

New Zealand's approach for this VRM submission: transparency of New Zealand's fossil fuel "support measures"

8 New Zealand's approach for this VRM submission is to provide transparency around its fossil fuel support measures. To this end, information published by the OECD in its 2011 *Inventory of Estimated Budgetary Support and Tax Expenditures Relating to Fossil Fuels in Selected OECD Countries* (the **OECD Inventory**) is drawn upon.

9 The OECD Inventory was a "first attempt" to comprehensively list the various direct budgetary and tax expenditures that effectively support fossil fuel consumption and production in OECD countries. However, the Inventory avoids assessments of whether identified measures equate to inefficient subsidies.

10 New Zealand welcomed the Inventory for its contribution to improved transparency. The Inventory was a first step on the path to determining which policies of individual countries may constitute inefficient subsidies.

11 While New Zealand does not consider that it currently has any inefficient fossil fuel subsidies, in the interest of transparency, New Zealand has:

a. based its VRM submission on support measures listed in OECD Inventory;
b. shared lessons from the historical evolution of support measures and subsidies; and
c. described policy reviews that are underway that look at whether support measures are still justified.

New Zealand's Response to VRM questions

Current fossil fuel support measures contained in OECD Inventory

Q1. What inefficient fossil fuel subsidies that encourage wasteful fossil fuel consumption does your economy currently have?

12 New Zealand does not currently operate any inefficient fossil fuel subsidies. In the interest of transparency, the response to this question is based on information published in the OECD Inventory. New Zealand fossil fuel support measures are summarised in Annex A.

Targeting support to those in need

Q2. What measures has your economy taken to specifically target inefficient fossil fuel subsidies toward providing those in need with essential energy services?

13 New Zealand does not currently have any measures that target fossil fuel support to those in need.

Historic evolution of petroleum tax and royalty policy

Q3. What measures has your economy taken to identify and reduce inefficient fossil fuel subsidies?

14 New Zealand has historically undertaken a number of reforms related to the tax and royalty regimes of petroleum mining. Rather than discuss measures that New Zealand has taken to identify and reduce inefficient fossil fuel subsidies, in this section we aim to discuss reforms of these support measures with a view to promoting transparency, sharing experiences, and gleaning lessons.

15 It is useful to note the context of a number of the New Zealand producer support measures listed in the OECD Inventory. The reserves of New Zealand's Maui gas field (the primary source of gas in New Zealand since 1979) were significantly downgraded in 2003, resulting in total gas reserves being sufficient to meet demand only through to around 2010. Further, artificially low prices for Maui gas that resulted from legacy contracts had been suppressing exploration activity in New Zealand.

16 At that time, as today, indigenous natural gas fuelled about 20% of electricity generation, meaning that the downgrade had significant implications for electricity security of supply. New Zealand does not have gas importation infrastructure so indigenous security of supply is critical. A number of the New Zealand producer support measures listed in the OECD Inventory were developed in 2004 to encourage further gas exploration.

Tax deductions for petroleum-mining expenditures

17 New Zealand undertook a series of tax reforms in the 1980s that were designed to remove distortions in the economy by broadening the tax base and lowering tax rates. In particular, there was a reduction of a number of concessions for petroleum exploration and production.

18 In 1991 the Government announced another round of reforms for petroleum exploration and production activities "*in order to eliminate the… punitive tax treatment of petroleum exploration and development expenditure, both onshore and offshore*". The reforms were intended to achieve broad international comparability of tax treatment of petroleum exploration and development expenditure. The key elements of the reforms resulted in:

a. exploration expenditures being deductible in the year incurred; and

b. development expenditure being capitalised and deductible over seven years, with deductions beginning in the first year of commercial production for onshore projects and from the year incurred for offshore developments.

19 Following the downgrade of the Maui field in 2004, further changes to tax rules on exploration and development expenditure were made that would come into effect in 2008:

a. development expenditure could be allocated using a seven year straight line method or using a reserve depletion method;

b. development expenditure allocated to future income years could become deductible in full in the income year in which a permit is relinquished or disposed of for consideration;

c. costs relating to failed production wells could be deducted in the year of abandonment, instead of deductions being spread over seven years; and

d. deductions for onshore production could begin in the year that costs are incurred (as per the offshore regime).

20 The primary policy rationale behind the current petroleum exploration and mining tax regime is to ensure that New Zealand's tax treatment is not out of line with its major competitors thereby disincentivising investment. Further, as mentioned above, some rules were put in place to encourage exploration for gas to improve New Zealand's gas and electricity security of supply.

Reduction in royalty payments for petroleum

21 In 2004, a temporary reduction on the royalty rates for any gas discovery made between 30 June 2004 and 31 December 2009 was put in place to encourage gas exploration:

a. The ad valorem component of the royalty for gas was reduced from 5% to 1%.

b. The accounting profit component of the royalty was reduced from 20% to 15% on the first $750m (cumulative) gross sales from an offshore discovery and the first $250m (cumulative) gross sales from an onshore discovery. The royalty remained at 20% for any production above those thresholds.

22 These were temporary measures to encourage a burst of exploration and are no longer in place. One new gas reserve was discovered during the applicable period and is paying reduced royalty rates accordingly.

23 A 2012 review of New Zealand's petroleum royalty regime found that there are no major concerns with the current royalty regime. The regime is competitive with other jurisdictions and is considered appropriate given the country's geological risk profile.

Non-resident drilling rig and seismic ship tax exemption

24 In 2004, a temporary tax exemption was introduced, currently available until December 2014, which provides an exemption from New Zealand tax to a non-resident on income earned in New Zealand from operating seismic survey vessels and offshore drilling rigs.

25 New Zealand's domestic income tax rules generally tax non-resident offshore rig operators and seismic vessels on their New Zealand sourced income. However, in some situations where non-residents come from a country with which New Zealand has a double tax agreement, the non-resident rig operators will be exempt from tax in New Zealand if they stay for less than 183 days in any 12 month period. If they stay for more than 183 days a claw back of tax on all income will result from the first day of presence in New Zealand.

26 In the period leading up to the temporary tax exemption, non-resident offshore rig operators and seismic vessels had tended to stay in New Zealand for a period of less than 183 days. Even if further exploration would be desirable beyond the 183 day window, there were strong incentives for rigs to leave by this time. Different rigs were then required to be brought to New Zealand to complete the work, causing extra mobilisation and demobilisation costs. This also disrupted sensible exploration and development programmes.

27 In the period leading up to the temporary tax exemption, there were no cases of semi-submersible or seismic ships breaching the 183 day rule and becoming subject to New Zealand income tax, and therefore no tax revenues were being raised from these ships (jack-up rigs had always tended to stay longer than 183 days). In fact, the 183 day rule had the potential to lower New Zealand tax collections by lowering the profits of the New Zealand exploration firms engaging the services of these ships.

28 The temporary taxation exemption has had a demonstrable positive impact, with non-resident semi-submersible rigs and seismic vessels extending their length of stay in New Zealand beyond 183 days. Moreover, the numbers of offshore rigs, offshore wells drilled and offshore gas reserves booked have all increased.

Past reforms of fossil fuel subsidies

Q4. If your economy has undertaken reform of inefficient fossil fuel subsidies, please answer the following regarding the reform:

a. What was the estimated amount/size of subsidy per unit before reform?

b. What is the total budgetary impact of reform?

c. *Who was eligible for subsidies before the reform?*

d. *Who was eligible for subsidies after the reform?*

e. *Describe how this reform benefits vulnerable populations or provides essential energy services to those in need.*

f. *When was the reform undertaken, and has it maintained?*

29 There is one significant historical example of direct support for fossil fuel consumption in New Zealand. Following the 1970s oil crises, and the discovery of large New Zealand gas reserves around that time, the government implemented policies to encourage switching from vehicle fuels derived from imported oil, to fuels derived from indigenous gas (CNG and LPG). It is likely that the rationales for these policies were to reduce reliance on imported fuels, and to make use of the recently discovered gas reserves.

30 In 1978 a tax incentive scheme was introduced that covered the conversion of business road vehicles to LPG and the installation of new LPG storage spheres/tanks exceeding 100,000 litres. Further, cash grants were provided to businesses that sold, used, or distributed LPG and CNG.

31 In subsequent years the Government also provided grants, loans, information publicity and support to encourage LPG and CNG uptake. By January 1985 over 75 000 vehicles had been converted to CNG and 20 000 to LPG. There were 215 public CNG stations in operation and a further 185 under development, and 250 public LPG stations in operation.

32 Most subsidies for CNG and LPG were removed in 1987 following the drop in the global oil price. CNG use dropped significantly following this, with LPG demand tailing off more slowly.

Lesson learned from past reforms

Q5. What "lessons learned" would your economy be willing to share with APEC members regarding fossil fuel subsidy reform?

33 The main evidence provided by New Zealand's history of government involvement in the fossil fuel industry can be seen primarily as an argument against interventions and controls that limit the ability of markets to deal with changing circumstances. Such interventions can also lead to inefficiencies in energy markets. Balancing that, however, is the government's need to ensure security of supply of energy and its availability to the population.

34 The differential tax treatment accorded to oil and gas exploration and development activities reflects a deliberate policy decision based on economic development and security of supply concerns, and a need to maintain international competitiveness to attract such activities. Competition between tax regimes might point to the need for multilateral reform in this area.

Plans for implementing the APEC Leaders' commitment

Q6. What are your plans for implementing the APEC Leaders' commitment in the coming year?

35 While New Zealand does not consider that it has any inefficient fossil fuel subsidies, as part of regulatory practice, New Zealand may periodically review fossil fuel support measures such as those identified in the OECD Inventory. Such reviews ensure that policies are still achieving relevant objectives.

36 New Zealand has recently undertaken reviews of two policies identified in the OECD Inventory:

a. a review of petroleum royalties[1]; and

b. a review of the funding mechanism for IEA oil stocks[2].

37 The review of petroleum royalties found that there were no major concerns with the current royalty regime. The regime is competitive with other jurisdictions and is considered appropriate given the country's geological risk profile.

38 The review of the funding model for New Zealand's IEA oil stocks found that it may be more economically efficient for the stockholding to be funded by a levy on fuels rather than directly by the Crown through general taxation. A proposal to fund the stockholding by a levy on fuel is presently being consulted on and a final decision will be made in due course.

Monitoring of subsidy reduction

Q7. How will your economy monitor the implementation of subsidy reform; measure the effectiveness of its subsidy reduction; and monitor for undesirable secondary effects of subsidy reduction? Please describe the indicators used and lessons learned in this area.

39 New Zealand does not consider that it has any inefficient fossil fuel subsidies. As mentioned above, New Zealand may periodically review policies that affect fossil fuel production or consumption to ensure that they are achieving policy objectives.

[1] http://www.med.govt.nz/sectors-industries/natural-resources/oil-and-gas/review-of-the-crown-minerals-act-regime/royalties-companion-paper

[2] http://www.med.govt.nz/sectors-industries/energy/energy-security/oil-security/oil-security-review-2012

Annex A: New Zealand's fossil fuel support measures

New Zealand's measures listed in the OECD Inventory generally fall into one of three categories:

- on-going policies that may be reviewed periodically;
- policies that have expired; and
- temporary policy measures that have an expiration date.

The table below summarises the fossil fuel support measures contained in the OECD Inventory, and their categorisations.

	Policy measure	*Description*	*Status*
Producer support estimate	Tax Deductions for Petroleum-Mining Expenditure	Specific exploration and development expenditure deductions for petroleum designed to ensure that New Zealand's tax regime is not out of line with that of competing jurisdictions.	On-going policy
	Reduction in Royalty Payments for Petroleum	Temporary reduction on the royalty rates for any gas discovery made between June 2004 and December 2009. Designed to encourage a burst of activity when security of gas supply was in question.	Expired
	Non-Resident Drilling Rig and Seismic Ship Tax Exemption	Temporary exemption for non-resident offshore rig and seismic ship operators conducting exploration and development activities from paying tax in New Zealand on their profits. Designed to remove inefficient tax avoidance behaviour.	Measure is set to expire in 2014 at which time policy will be reviewed
Consumer support estimate	Motor-spirit excise duty refund to off-road vehicles	Measure that refunds road user charges to vehicles that do not use roads.	On-going policy
	Risk-sharing agreement with Genesis Energy	Electricity generation gas supply risk underwriting by government at a time of uncertain electricity security of supply.	Expires in 2014
General service support estimates	Research and development	Funding for various fossil fuel related R&D.	Continues as part of broader R&D funding regime. Periodically reviewed as part of broader regime.
	Acquisition of petroleum exploration data	Since 2004 the New Zealand Government has invested around $35m into public good initiatives to improve the quality and availability of pre-commercial geological information about New Zealand's offshore petroleum basins.	Policy will be reviewed before a decision on whether to extend is made.
	Management of IEA oil stocks	Government funding for New Zealand's contribution to IEA global strategic oil stockholding.	Review of oil security underway which includes a review of funding mechanism for IEA oil stocks