

The Auditor-General
Audit Report No.33 2008–09
Performance Audit

Administration of the Petroleum Resource Rent Tax

Australian Taxation Office

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of Australia 2009

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Canberra ACT
20 May 2009

Dear Mr President
Dear Mr Speaker

The Australian National Audit Office has undertaken a performance audit in the Australian Taxation Office in accordance with the authority contained in the *Auditor-General Act 1997*. Pursuant to Senate Standing Order 166 relating to the presentation of documents when the Senate is not sitting, I present the report of this audit and the accompanying brochure. The report is titled *Administration of the Petroleum Resource Rent Tax*.

Following its tabling in Parliament, the report will be placed on the Australian National Audit Office's Homepage—<http://www.anao.gov.au>.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Ian McPhee', is positioned above the printed name.

Ian McPhee
Auditor-General

The Honourable the President of the Senate
The Honourable the Speaker of the House of Representatives
Parliament House
Canberra ACT

AUDITING FOR AUSTRALIA

The Auditor-General is head of the Australian National Audit Office (ANAO). The ANAO assists the Auditor-General to carry out his duties under the *Auditor-General Act 1997* to undertake performance audits and financial statement audits of Commonwealth public sector bodies and to provide independent reports and advice for the Parliament, the Australian Government and the community. The aim is to improve Commonwealth public sector administration and accountability.

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Abbreviations

ABN	Australian Business Number
AIS	ATO Integrated System
ANAO	Australian National Audit Office
APPEA	Australian Petroleum Production and Exploration Association
ATOID	ATO Interpretative Decision
CAC	Client Activity Centre
JCPAA	Joint Committee of Public Accounts and Audit
LB&I	Large Business and International Business Line
MLMDQ	Maximum Limit of Maximum Daily Quantity
MPC	Marketable petroleum commodity
PICS 2007	<i>Petroleum Industry Compliance Strategy 2007</i>
PRRT	Petroleum Resource Rent Tax
PRRTA Act	<i>Petroleum Resource Rent Tax Assessment Act 1987</i>
RAB	Revenue Analysis Branch
RET	Department of Resources, Energy and Tourism
Tax Office	Australian Taxation Office
The Commissioner	Commissioner of Taxation
Treasury	Department of the Treasury

Summary and Recommendations

Summary

Introduction

1. A reliable and competitively priced supply of petroleum products is essential to the effective functioning of the Australian economy and to maintain living standards. Petroleum is the energy source for over 50 per cent of Australia's primary energy consumption, and supplies nearly all of Australia's transport energy requirements.¹

2. The oil and gas industry² is an important contributor to the Australian economy. In 2006–07, the industry accounted for 2.1 per cent of nominal Gross Domestic Product and generated estimated revenue of \$28 billion.³ Industry revenue expanded strongly between 2003–04 and 2007–08, reflecting large increases in oil and gas prices. However, oil prices fell substantially in late 2008, reversing the trend. Geoscience Australia has forecast that crude oil production will fall in coming years, while Australia's natural gas production levels will almost double in the five years to 2012.

3. The Petroleum Resource Rent Tax (PRRT) is imposed by the *Petroleum Resource Rent Tax Assessment Act 1987* (PRRTA Act), which came into force from 15 January 1988. The PRRT is a profit-based tax levied on most offshore petroleum projects.⁴ PRRT is applied to the recovery of all marketable petroleum commodities (MPCs),⁵ including crude oil, condensate, liquefied

¹ Australian Petroleum Production and Exploration Association (APPEA), *Submission to the Senate Rural and Regional Affairs and Transport References Committee inquiry into Australia's future oil supply and alternative transport fuels*, April 2006, p. 2.

² Oil and gas are petroleum resources and products. The main forms of oil are crude oil, distillate and liquefied petroleum gas, while the main forms of gas are natural gas and liquefied natural gas. Petroleum production and exploration represent the upstream petroleum industry. The downstream petroleum industry mainly comprises refining, transportation and retailing of petroleum products.

³ Crude oil accounted for around 35 per cent of oil and gas extraction industry output in 2006–07. About 55 per cent of crude oil output was exported, with the remainder supplied to the domestic petroleum refining industry. The production of natural gas accounted for about 60 per cent of the industry's output in 2006–07. About 43 per cent of Australia's natural gas production was exported in the form of liquefied natural gas. Most of the remainder was purchased and distributed by firms operating in the gas supply industry.

⁴ A project consists of facilities in the project title area, and any facilities outside that area necessary for the production and initial storage of marketable petroleum commodities. Each entity with an interest in a PRRT liable project will be liable for PRRT. In essence, each entity's interest in a project becomes a 'taxing entity'.

⁵ An MPC is a marketable product that can be sold. It establishes the point at which petroleum recovery stops and other activity begins.

petroleum gas, natural gas and ethane, from Australian Government waters.⁶ The PRRT is not applied to value added products such as liquefied natural gas or petroleum products extracted from the North West Shelf project and the Joint Petroleum Development Area.⁷

4. The PRRT aims to encourage the exploration and production of petroleum while ensuring an adequate return to the community for the development of its petroleum deposits. The PRRT is levied at a rate of 40 per cent of a project's taxable profit. Taxable profit is the project's income after all project and 'other' exploration expenditures⁸ have been deducted from all assessable receipts. Other key features of the PRRT include:

- it is assessed on a project basis;
- liability to pay PRRT is on a producer/company basis;
- PRRT is levied before company tax, and PRRT payments are deductible for company tax purposes;
- any excess of expenditure over receipts can be compounded forward for deduction against future receipts from the project;
- the rates at which undeducted expenditures are compounded forward depends on the nature of those expenditures and when they were incurred before the granting of a production licence; and
- deductions include capital and operating costs that directly relate to the petroleum project, and are deductible in the year they are incurred.

5. The PRRT is a significant secondary tax, which has generated over \$22 billion for the Commonwealth Government since it was first collected in

⁶ Under the terms of the 1979 Offshore Constitutional Settlement and the division of powers provided for under the Australian Constitution, the power to impose taxation and other charges on oil and gas production has been divided between the Commonwealth and States/Territories. The Commonwealth holds title for all areas seawards of the outer boundary of the territorial sea while the States/Territories control areas landwards of this boundary. As part of the Settlement, a common mining code was adopted covering all petroleum regulation in submerged lands.
<http://www.appea.com.au/index.php?option=com_content&task=view&id=25&Itemid=47> [accessed 24 April 2009].

⁷ The *Timor Sea Treaty* came into force on 2 April 2003 and sets out the framework for joint administration and revenue sharing by Australia and East Timor of petroleum exploration and development in an agreed area of the Timor Sea—the Joint Petroleum Development Area.

⁸ All eligible project expenditures are tax deductible for PRRT purposes in the year incurred. There is no distinction between capital and revenue expenditures for this purpose. Eligible expenditures include exploration and project development and operating expenditures, subject to the specific exclusions.

1989. PRRT annual gross revenue averaged slightly over \$1.5 billion between 2001–02 and 2007–08, which was nearly 30 per cent of the \$5.4 billion tax paid each year by the oil and gas exploration and production industry.⁹

6. In October 2008, there were 65 separate PRRT registrations across 24 projects. Only 10 projects, and 9 company groups, were making profits and therefore paying the tax. There was a high degree of concentration in PRRT payments, with one project providing a significant majority of all PRRT revenue in 2007–08, and the top five projects providing over 95 per cent of all revenue.

7. The Australian Taxation Office (Tax Office), as Australia's principal revenue agency, has responsibility for administering Australia's revenue system under the law. The Energy and Resources Segment within the Tax Office's Large Business and International Business Line, has responsibility for administering the PRRT for the Tax Office. In 2007, primary responsibility for administering the PRRT was transferred from the Moonee Ponds Office in Melbourne to a PRRT unit in Northbridge, Perth.¹⁰

Audit objective and scope

8. The objective of the audit was to assess the effectiveness of the Tax Office's administration of the PRRT. The Australian National Audit Office (ANAO) identified four key areas for review: general administration; compliance; promoting certainty in administering the PRRT; and governance arrangements.

9. As with other taxes, risk management is the key to the effective administration of the PRRT. The ANAO examination therefore focused on how the Tax Office assesses and manages risks associated with the PRRT and what assurance is provided on those risks resulting from its approaches to encouraging taxpayer compliance.

10. The ANAO conducted fieldwork in the Tax Office's Northbridge and Moonee Ponds offices between August and December 2008. The ANAO also consulted a range of stakeholders including: the Australian Petroleum

⁹ Estimates of total tax for the oil and gas extraction industry are from APPEA *Annual Financial Survey* results. These results indicated that taxes and charges represented 38 per cent of industry costs between 2001–02 and 2006–07.

¹⁰ The Moonee Ponds team retains some PRRT responsibilities, particularly relating to specific taxpayers.

Production and Exploration Association (APPEA); major Australian oil and gas companies;¹¹ the Department of the Treasury; and the Department of Resources, Energy and Tourism.

Conclusion

11. Overall, the Tax Office has administered the PRRT in a generally effective manner, which has supported voluntary compliance by taxpayers. The vast majority of PRRT taxes are paid promptly in accordance with administrative arrangements that underpin the self-assessment system. Compliance activities are being undertaken according to the Tax Office's risk-based strategy following the recent increase in coverage, general administration of the PRRT is sound, and governance arrangements are suitable. Most petroleum industry stakeholders are satisfied with those elements of administration but expressed major concerns about the time taken by the Tax Office deliberating on a number of PRRT technical issues, which are yet to be resolved.¹² To provide taxpayers with greater certainty in applying the PRRTA Act, it is important that the Tax Office continues to build on recent increases in the provision of guidance and advice, and allocates adequate technical support resources to PRRT.

12. More specifically, taxpayer uncertainty in applying the PRRTA Act arises when the Tax Office's position is not understood, or because of differences in interpretation of the PRRTA Act. In this regard, most industry representatives contacted as part of the audit informed the ANAO that they were seeking a clear articulation of the Tax Office's position on many technical PRRT issues, which would include practical examples, such as those categories of expenditure that could (and could not) be included as eligible indirect expenditure. On this basis, many industry representatives considered that after 20 years of operation the current level of uncertainty in applying the PRRT was unacceptable. These representatives noted that the level of uncertainty has led to many different interpretations of key aspects of the tax. The Tax Office has recognised the importance of increasing the extent of guidance on PRRT laws,

¹¹ The ANAO held discussions with 11 PRRT taxpayers or their tax agents. These companies and agents represented over 90 per cent of companies paying PRRT and of total PRRT revenue in 2007–08.

¹² Uncertainty in the interpretation of two issues, the classification of indirect expenditures and determining the taxing point for gas, has involved two large PRRT taxpayers and has been ongoing for each year of assessment since the early 1990s. The total amount of PRRT revenue affected by disputes is potentially over \$1 billion or around five per cent of total collections since inception.

and issued three public rulings on key aspects of the PRRT between September 2008 and February 2009. The Tax Office is also in the process of identifying high priority technical PRRT issues to form a program of work to provide further guidance to taxpayers.

13. Recognising a lack of coverage in previous years, there was a significant increase in the number of PRRT risk reviews and audits in 2008–09, which, if maintained at these levels, would satisfy the requirements of the Tax Office’s risk-based compliance strategy. These compliance activities have covered relevant risks and issues, collected sufficient information, which was analysed thoroughly, and had successful outcomes. Taxpayers advised that these activities have created a fairly large administrative burden, particularly on those companies that are not the operators of a petroleum project. The time taken to complete risk reviews was typically close to relevant benchmark targets, but much longer than the benchmark for the major PRRT audit underway at the time of ANAO fieldwork. There is scope to increase the extent to which apparent inconsistencies in information provided by taxpayers on instalment statements and annual returns are addressed in a timely way. This has potential benefits to both the Tax Office and taxpayers in minimising the impact of taxpayer errors.

14. The Tax Office effectively undertakes the core administrative elements of the PRRT—identifying and registering taxpayers, processing PRRT payments, and providing refunds. PRRT debt recovery is rarely an issue.

15. The Tax Office’s governance arrangements for PRRT adequately support key processes and practices, including those relating to the provision of interpretative assistance and advice, compliance activities and general administration. Line management responsibilities are clearly established and there are appropriate mechanisms to liaise with industry stakeholders. Scope exists, however, to usefully extend the PRRT planning framework by enhancing key performance indicators to better monitor and report on the achievement of strategic goals.

Key findings by chapter

General administration (Chapter 2)

16. As reflected in the findings of this audit, petroleum industry stakeholders considered that Tax Office general administration processes and practices were sound, with very few problems encountered with registration processes, submitting PRRT payments and receiving refunds.

17. PRRT registration processes were streamlined and straightforward, collecting sufficient information to allow the Tax Office to effectively process annual returns and quarterly instalments. The Tax Office was aware of petroleum projects that should be subject to PRRT and were taking adequate steps to ensure all relevant companies were registered.

18. Audit testing found that all PRRT quarterly instalment and annual PRRT payments had been correctly accounted for in 2007–08. Amounts on instalment notices or annual statements in all 49 cases in 2007–08 matched amounts actually paid to the Tax Office, posted to the Tax Office computerised financial system and recorded in PRRT operational spreadsheets. There was evidence that the PRRT Unit had undertaken substantial checking to assure the accuracy of processing PRRT payments. The Tax Office had refunded all PRRT over-payments accurately and promptly in 2006–07 and 2007–08.

19. Largely reflecting the volatility of oil prices, exchange rates and resource costs, actual PRRT revenue varied from official forecasts by over 30 per cent in three of the five years from 2003–04 to 2007–08, and the average error in forecasts over this period was 27 per cent. While communication arrangements between the PRRT Unit and Revenue Analysis Branch in place at the time of audit fieldwork adequately supported Tax Office forecasts of PRRT revenue, it is important that the Tax Office reviews the appropriateness of these arrangements on a periodic basis, given the extent of volatility in actual PRRT revenues and the difficulties involved in providing accurate forecasts.

Compliance (Chapter 3)

20. PRRT compliance plans form part of a cohesive line management approach, involving the Energy and Resources Segment, Large Business and International Business Line and Tax Office wide compliance planning documents and approaches. Compliance planning approaches for PRRT are consistent with, and integrated into, broader compliance approaches in the Tax Office. The *Petroleum Industry Compliance Strategy 2007* was a useful means of

updating petroleum industry tax risks and determining compliance and related strategies for PRRT and income tax in following years. One aspect for the Tax Office to consider in any future updates of this strategy would be increasing the extent of analysis of PRRT-related information.

21. The Tax Office has a sound understanding of most PRRT projects and participants that have paid PRRT. There has also been a stream of projects entering the PRRT environment in recent years. While participants in these projects may not pay PRRT for a number of years, profiling them would support effective ongoing monitoring and inform future compliance case selections. The extensiveness of profiling would depend on assessed compliance risks.

22. Largely in response to the change in PRRT administration to a self-assessment basis in 2007, the Tax Office has placed greater emphasis on active compliance (risk reviews and audits) rather than addressing potential inconsistencies on a timely basis. While recognising this approach, the ANAO considers there is scope to increase the extent to which apparent inconsistencies are addressed in a timely way, particularly in circumstances with significant tax liability implications for clients.

23. PRRT compliance activities are undertaken in accordance with guidelines established for income tax purposes, and include risk reviews and audits. As discussed in paragraph 13, the Tax Office greatly enhanced its PRRT compliance activities in 2008–09, with substantially more risk reviews and audits. Recent PRRT risk reviews have generally been completed in a timely manner. However, based on progress at the time of ANAO fieldwork, a large PRRT audit is likely to take double the benchmark of two years to complete.

24. The four PRRT risk reviews examined by the ANAO were soundly based. They covered key PRRT risks,¹³ collected considerable information from the clients as evidence, and analysed this information thoroughly. PRRT compliance activities have sometimes raised substantial additional revenue, and in other instances provided assurance that no material risks were outstanding.

25. The current company income tax return does not identify the amount being claimed as a deduction for PRRT payments. This means the Tax Office is

¹³ These risks include shares of income and expenditure, taxing points, excluded and indirect expenditure, foreign exchange calculations and sale of holdings.

only able to match PRRT payments and income tax deductions in risk reviews conducted as part of a compliance process. However, the Tax Office has not included this matching exercise in its program of risk reviews and audits.

Promoting certainty in administering the PRRT (Chapter 4)

26. While there is no dispute between the Tax Office and the majority of taxpayers on most elements of the PRRTA Act, there remains uncertainty in the interpretation of a number of technical PRRT issues. Notwithstanding that the Tax Office had discussed these issues with stakeholders, nine of the 11 petroleum stakeholders contacted as part of this audit advised that they faced considerable uncertainty in assessing PRRT liabilities. Similarly, nine of the 11 industry representatives considered that the Tax Office has provided insufficient guidance to explain its position on a number of key contentious issues. The overall level of public guidance remains low, although the Tax Office has taken actions to increase the level of interpretative assistance and advice to PRRT taxpayers in recent times.

27. Private Binding Rulings are one of the key mechanisms in Australia's self-assessment system to provide taxpayers with certainty of tax treatment concerning their specific circumstances. Nevertheless, despite the complexity of PRRT issues and the level of sophistication of the taxpayers involved, only two PRRT taxpayers have entered into Private Binding Rulings with the Tax Office. A major reason cited to the ANAO by petroleum companies that have not sought these rulings was that they consider it likely that the rulings would not favour them. These taxpayers consider that taking a reasonably arguable position was preferable to applying for a Private Binding Ruling.

28. There was relatively little litigation for the first 15 years of operation of the PRRT, but this increased markedly from around 2002. Of 10 PRRT litigation cases since 2002, seven have been resolved in some way, with results mixed but generally favouring the Tax Commissioner.

29. In disputes about technical PRRT issues, the Tax Office and petroleum companies have sometimes 'agreed to disagree' on PRRT interpretations and to have the matter decided by a court. However, one company in litigation with the Tax Office over PRRT, and a number of other petroleum industry stakeholders, perceive that the Tax Office has a general pro-revenue bias when administering the PRRT. These stakeholders advised that this has also been a reason for the small number of applications for Private Binding Rulings. With respect to these rulings, perceptions of general pro-revenue bias are common

amongst big business generally, but were not substantiated in a review by the Inspector-General of Taxation.¹⁴ Consistent with this finding, a limited review of Tax Office files by the ANAO did not identify evidence that would substantiate claims of a general pro-revenue bias by the Tax Office when administering the PRRT.

30. The main reason suggested by the Inspector-General for a perception of a general pro-revenue bias by large companies is relevant to petroleum companies paying PRRT. That is, a lack of transparency in disclosing the full circumstances and reasons for interpreting key elements of tax law leaves taxpayers little to go on but their own views of what may be happening. The Tax Office is taking steps to improve transparency in interpreting the PRRTA Act by increasing the extensiveness of public rulings and other advice, and increasing communication with taxpayers to determine positions on emerging issues such as gas-to-liquids. However, there is scope to further improve the extent and effectiveness of these activities.

31. Representatives of the petroleum industry typically supported the Department of the Treasury and the Department of Resources, Energy and Tourism having a role in providing advice on technical PRRT issues, including on matters under dispute with the Tax Office. The Tax Office has sometimes brought such issues to the attention of these agencies, albeit through discussions that are not part of defined processes for considering legislative amendment. However, the Tax Office has identified scope to improve the extent of collaboration with other government agencies to provide input to issues involving legislative and administrative issues regarding the PRRT. Taking action to improve this collaboration, and then advising industry of its existence and the key issues being discussed, is likely to improve perceptions that the Australian Government is taking a suitably coordinated approach to administering the PRRT.

32. To effectively manage the recent increase in litigation and deal with disputes about technical PRRT matters in a timely manner, it is important that the Tax Office allocates an adequate level of resourcing for the PRRT Centre of Expertise. While resource requirements will depend on the scale of the future technical PRRT programme, it is likely that the increase in staffing would be in

¹⁴ Inspector-General of Taxation, *Review of the potential revenue bias in private binding rulings involving large complex matters* (2008), p. 3.

the magnitude of contributions from two additional senior lawyers to supplement the existing officer.

33. Since inception, there have been a number of legislative changes to the PRRT. Audit testing revealed that the Tax Office effectively implemented the seven major amendments to the PRRT which became effective from 1 July 2006.

Governance arrangements (Chapter 5)

34. Current administrative structures for PRRT provide: clear lines of responsibility through to the Tax Commissioner; alignment of PRRT and company tax within a petroleum unit that facilitates synergistic use of expertise; and the use of client managers who aim to obtain a thorough knowledge of petroleum projects to enable informed discussions with stakeholders. The two office approach reflects the geographic distribution of petroleum projects, with the Perth office having primary responsibility for projects in the petroleum growth area of Western Australia, and the Melbourne office retaining a local presence for Victorian producers. As yet, however, there has been insufficient time and information to determine the success of this approach. Stakeholders generally were satisfied with PRRT administrative arrangements.

35. ANAO fieldwork and views of stakeholders indicate that skilling levels are generally high for PRRT administration, and have been improving in Northbridge as staff gain experience following the establishment of the PRRT Unit in 2007. Updating two key PRRT reference guides will also support PRRT capability.

36. PRRT strategic planning documentation was effectively integrated with the Tax Office's broader planning framework. However, there is scope to extend the PRRT planning and internal reporting framework. Extending annual *PRRT Compliance Strategies* to include performance indicators, and expressly monitoring performance against these indicators, would allow the Tax Office to gauge its success in implementing key PRRT strategies, and support continual improvement in performance. To help ensure consistency with broad Tax Office reporting approaches, it is important that the development of any performance indicators for PRRT is undertaken within current systems and reporting frameworks.

37. The Tax Office utilises a variety of forums to report on PRRT activities including its Annual Report, specific publications, media releases, the Internet,

and speeches. These forums provide generally adequate external reporting of PRRT administration. To comply with Section 16(1) of the PRRTA Act, details of any breaches or evasions of the PRRT should be included in Commissioner of Taxation Annual Reports, or alternatively noted if there were no known breaches or evasions.

38. The full cost to the Tax Office of administering the PRRT is not known but is likely to be low compared to the magnitude of revenue collected.¹⁵ Compliance costs to industry are also important. A common view of petroleum industry representatives contacted as part of the audit was that: compliance costs for general PRRT administration were reasonable; costs of responding to risk reviews could be quite high; and the cost of litigation was high (but worth clarifying through the court given the amounts of tax involved).

Tax Office response

39. The Tax Office's summary response to the report is reproduced below.

As you noted, the Petroleum Resource Rent Tax (PRRT) has been administered by the Tax Office since its introduction in 1987. In the 2008 year it generated approximately \$1.7 billion in revenue for the Commonwealth Government, out of \$271 billion collected by the Tax Office. This means it is a comparatively small, but nonetheless important, revenue product.

The Tax Office welcomes the ANAO recommendations on its administration of the PRRT.

It is encouraging to note that the ANAO found that the Tax Office's recent steps to improve its administration have been effective. In particular, we were pleased to note the ANAO found:

- the Tax Office effectively undertakes the core administrative elements of the PRRT, which was supported by industry stakeholders,
- PRRT compliance arrangements and the plans are cohesive and compliance activities are based on sound risk management processes,
- the Tax Office has taken action to increase the level of interpretative assistance and advice to PRRT taxpayers, and
- PRRT governance arrangements are sound.

¹⁵ For example, direct salary costs of the 12 full-time equivalent staff working on PRRT in 2007–08 would have been well under one million dollars, which was around one twentieth of one per cent (0.05 per cent) of PRRT revenue raised.

It was also pleasing to note external stakeholders indicated that skilling levels of Tax Office staff are generally high for PRRT administration.

40. The Tax Office's full response can be found in Appendix 1.

Recommendations

Recommendation No. 1

Para 3.24

To better inform compliance programs and facilitate timely resolution of PRRT payment issues, the ANAO recommends that the Tax Office increases the extent to which it makes timely inquiries to resolve apparent PRRT payment anomalies, where this has significant tax liability implications for clients.

Tax Office response: *Agreed.*

Recommendation No. 2

Para 4.25

In light of the potential to reduce uncertainty for sophisticated taxpayers in interpreting complex issues with significant revenue implications, the ANAO recommends that the Tax Office provides more extensive written guidance about key aspects of the PRRT, through additional Public Rulings and other interpretative advice.

Tax Office response: *Agreed.*

Recommendation No. 3

Para 4.76

To enable timely and cost-effective resolution of technical PRRT issues, the ANAO recommends that the Tax Office strengthens the capacity of the PRRT Centre of Expertise by allocating sufficient time of additional senior lawyers from the Tax Counsel Network to adequately supplement the existing officer.

Tax Office response: *Agreed.*

**Recommendation
No. 4**

Para 5.28

To complete the planning framework for PRRT and support continual improvement in administration, the ANAO recommends that the Tax Office extends the approach taken in *2008–09 PRRT Compliance Strategies* to develop, monitor and report against key performance indicators for each recommended strategy.

Tax Office response: *Agreed in part.*

Audit Findings and Conclusions

1. Introduction

This chapter provides the context for the audit, including an overview of oil and gas extraction in Australia and the Petroleum Resources Rent Tax, and outlines the audit approach.

Oil and gas in Australia

1.1 A reliable and competitively priced supply of petroleum products is essential to the effective functioning of the Australian economy and to maintain living standards. Petroleum is the energy source for over 50 per cent of Australia's primary energy consumption and supplies nearly all of Australia's transport energy requirements.¹⁶

1.2 The oil and gas extraction industry¹⁷ is an important contributor to the Australian economy. In 2006–07 the industry accounted for 2.1 per cent of nominal Gross Domestic Product and generated estimated revenue of \$28 billion.¹⁸ Industry revenue expanded strongly between 2003–04 and 2007–08, reflecting large increases in oil and gas prices. However, oil prices fell substantially in late 2008, reversing the trend.

1.3 Historically, Australia has been a net exporter of oil, gas and petroleum derived products. Between 2003–04 and 2007–08, however, there was a dramatic reversal in the trade balance, as a consequence of both a rise in international energy prices and a fall in the level of domestic crude oil production.¹⁹ In 2006–07, imports exceeded exports of petroleum products by more than \$5 billion. Geoscience Australia has forecast that domestic crude oil production will fall in coming years, while Australia's natural gas production

¹⁶ Australian Petroleum Production and Exploration Association (APPEA), *Submission to the Senate Rural and Regional Affairs and Transport References Committee inquiry into Australia's future oil supply and alternative transport fuels*, April 2006, p. 2.

¹⁷ Oil and gas are petroleum resources and products. The main forms of oil are crude oil, distillate and liquefied petroleum gas, while the main forms of gas are natural gas and liquefied natural gas. Petroleum production and exploration represent the upstream petroleum industry. The downstream petroleum industry mainly comprises refining, transportation and retailing of petroleum products.

¹⁸ Crude oil accounted for around 35 per cent of oil and gas extraction industry output in 2006–07. About 55 per cent of crude oil output was exported, with the remainder supplied to the domestic petroleum refining industry. The production of natural gas accounted for about 60 per cent of the industry's output in 2006–07. About 43 per cent of Australia's natural gas production was exported in the form of liquefied natural gas. Most of the remainder was purchased and distributed by firms operating in the gas supply industry.

¹⁹ APPEA, *op. cit.*, p. 3.

levels will rise quite substantially and almost double within the five years to 2012.²⁰

1.4 While exploration expenditure tends to vary from year to year, being sensitive to the price of oil, the resources boom led to significant increases in expenditure between 2005 and mid-2008.

1.5 The oil and gas industry is a high-technology, capital-intensive industry with a complex value-adding chain and is dominated by a small number of large multinational explorers and producers. The industry has extensive international relationships through its overseas investments, joint venturers and local and overseas owners.

Petroleum Resource Rent Tax

1.6 The Petroleum Resource Rent Tax (PRRT) is a profit-based tax levied on most offshore petroleum projects. PRRT is applied to the recovery of marketable petroleum commodities (MPCs)²¹ from Australian Government waters.²² MPCs include crude oil, condensate, liquefied petroleum gas, natural gas and ethane. The PRRT is not applied to value added products such as liquefied natural gas or petroleum products extracted from the North West Shelf project and the Joint Petroleum Development Area.²³

1.7 The PRRT aims to encourage the exploration and production of petroleum while ensuring an adequate return to the community for the development of its petroleum deposits. The Australian Government introduced the PRRT because it considered that a resource rent tax related to

²⁰ Geoscience Australia Production and development - statistics, forecasts and descriptions. Available from <http://www.ga.gov.au/oceans/pgga_oqra2005_prod.jsp> [accessed 24 April 2009].

²¹ An MPC is a marketable product that can be sold. It establishes the point at which petroleum recovery stops and other activity begins.

²² Under the terms of the 1979 Offshore Constitutional Settlement and the division of powers provided for under the Australian Constitution, the power to impose taxation and other charges on oil and gas production has been divided between the Commonwealth and States/Territories. The Commonwealth holds title for all areas seawards of the outer boundary of the territorial sea while the States/Territories control areas landwards of this boundary. As part of the Settlement, a common mining code was adopted covering all petroleum regulation in submerged lands.
<http://www.appea.com.au/index.php?option=com_content&task=view&id=25&Itemid=47> [accessed 24 April 2009].

²³ The *Timor Sea Treaty* came into force on 2 April 2003 and sets out the framework for joint administration and revenue sharing by Australia and East Timor of petroleum exploration and development in an agreed area of the Timor Sea, the Joint Petroleum Development Area.

profits was a more efficient and equitable secondary taxation regime than the excise and royalty system that it replaced in 1988.

1.8 Figure 1.1 outlines the main features of the PRRT.

Figure 1.1

Main features of the PRRT

Features of the PRRT include that:

- it is assessed on a project basis;
- it is paid on a producer/company basis;
- it is levied before company tax;
- PRRT payments are deductible for company tax purposes;
- it is assessed at the rate of 40 per cent;
- liability for PRRT is incurred when all allowable expenditures, including compounding (see next point), have been deducted from assessable receipts;
- any excess of expenditure over receipts can be compounded forward (augmented) for deduction against future receipts from the project;
- the rates at which undeducted expenditures are compounded forward depends on the nature of those expenditures and when they were incurred before the granting of a production licence;
- deductions include capital and operating costs that directly relate to the petroleum project, and are deductible in the year they are incurred. Deductible expenditures include costs associated with exploration, development, operating and closing activities;
- expenditures which are not deductible include financing costs, indirect administration costs, income tax, and cash bidding payments;
- undeducted exploration expenditure incurred on or after 1 July 1990 can be transferred to other projects subject to conditions;
- assessable receipts include amounts received from the sale of all petroleum (or a marketable petroleum commodity) ; and
- projects incurring the PRRT are not subject to crude oil excise or royalties.

Source: ANAO analysis of Australian Taxation Office (Tax Office) information.

1.9 In short, the PRRT is levied at a rate of 40 per cent of a project's taxable profit. Taxable profit is the project's income after all project and 'other' exploration expenditures,²⁴ including a compounded amount for carried

²⁴ All eligible project expenditures are tax deductible for PRRT purposes in the year incurred. There is no distinction between 'capital' and 'revenue' expenditures for this purpose. Eligible expenditures include exploration and project development and operating expenditures, subject to the specific exclusions.

forward expenditures, have been deducted from all assessable receipts. PRRT payments are deductible for company income tax purposes.

Petroleum Resource Rent Tax Assessment Act 1987

1.10 The PRRT is imposed by the *Petroleum Resource Rent Tax Assessment Act 1987* (PRRTA Act), which came into force from 15 January 1988. Because the PRRT was levied on new, and not existing, projects, the Commonwealth Government first received PRRT revenue in 1989–90.²⁵

1.11 A number of amendments have been made to the Act since its inception, and these are set out in Appendix 2.

1.12 A petroleum project is based upon a production licence which is granted under the *Offshore Petroleum Act 2006*. Operations and facilities comprising a petroleum project are defined in Subsection 19(4) of the PRRTA Act to include:

- operations and facilities for the recovery of petroleum which extends to include platforms and drilling equipment;
- the movement of petroleum and any MPC for processing or storage. Movements of product may be by pipelines which are usually to onshore facilities, for storage or to processing;
- any processing of petroleum to produce an MPC, including stabilisation, water removal and separation of gas from liquids; and
- the movement of an MPC before it becomes an excluded commodity.²⁶

1.13 As an example, the area to which PRRT activities apply (often referred to as the ring fence) can extend beyond drilling platforms to include pipelines to an onshore treatment facility. Processing of crude oil/gas at the onshore treatment centre will produce an MPC available for sale and for delivery to a refinery and/or purchaser of the MPC. The ring fence does not extend to the second tier of processing—that is, where the MPC is further processed after being produced.

²⁵ Bass Strait gas production became subject to PRRT on the enactment of the *Petroleum Resource Rent Legislation Amendment Act 1991*. Prior to this date, Bass Strait gas production attracted a 10 per cent royalty, under the Commonwealth Government's excise and royalty regime.

²⁶ An excluded commodity is a marketable product that has been sold, or has been moved away from its place of production or initial on-site storage.

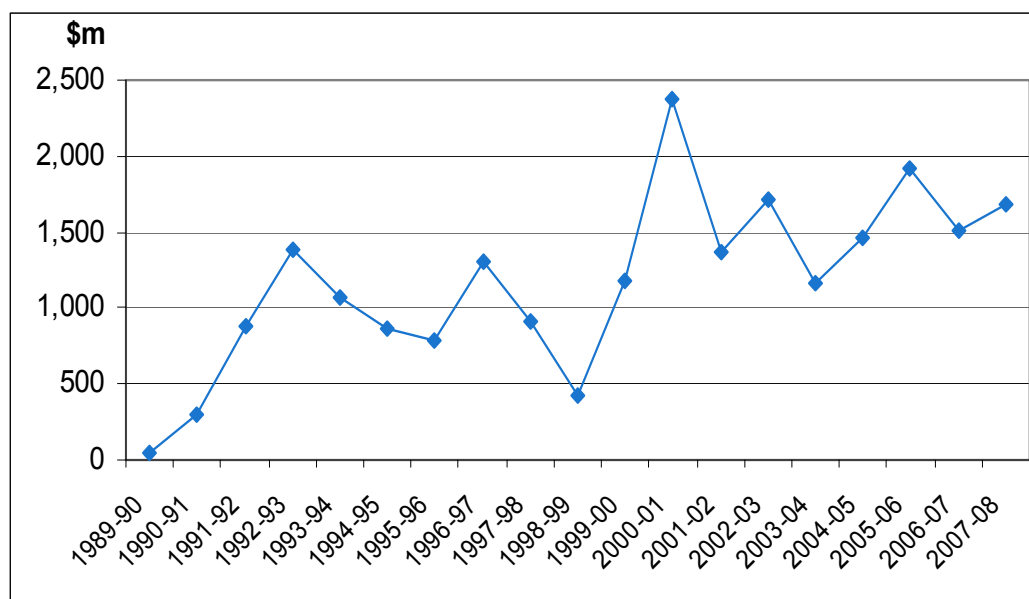
PRRT collections and profile of taxpayers

1.14 The PRRT is a significant secondary tax, which has generated over \$22 billion in revenue for the Australian Government since it was first collected in 1989. PRRT annual gross revenue averaged slightly over \$1.5 billion²⁷ between 2001–02 and 2007–08, which was nearly 30 per cent of the average \$5.4 billion tax paid each year by the oil and gas exploration and production industry.²⁸

1.15 PRRT collection commenced in 1989–90, peaked in 2000–01 at almost \$2.4 billion, and continued to vary considerably from year to year (see Figure 1.2). Key factors affecting PRRT revenues are production levels, prices, exchanges rates and exploration expenses.

Figure 1.2

PRRT revenue collected since inception (1989–90) to 2007–08



Source: 2000–01 Commonwealth Budget (Statement 5: Revenue) and Commissioner of Taxation Annual Reports 1998–99 to 2007–08.

²⁷ Net revenue to the Commonwealth from PRRT averaged slightly over \$1 billion over this period, assuming that taxpayers claimed all PRRT payments at the prevailing company tax rate of 30 per cent.

²⁸ Estimates of total tax for the oil and gas extraction industry are from APPEA *Annual Financial Survey* results. These results indicated that taxes and charges represented 38 per cent of industry costs between 2001–02 and 2006–07.

Profile of PRRT taxpayers

1.16 The PRRTA Act requires companies to provide an annual return when they commence generating assessable receipts from a project. Each partner for each project must separately provide an annual return (and quarterly instalment statements if PRRT is payable). In essence, each entity's interest in a project becomes a 'taxing entity'.

1.17 To facilitate payments, participants register for PRRT, separately for each share of equity in each project.²⁹ As at October 2008, there were 65 separate PRRT registrations across 24 projects. Only 10 projects, and 9 company groups, were making profits according to the PRRT regime, and therefore paid the tax in 2007–08 (see Table 1.1).

Table 1.1

Characteristics of PRRT taxpayers^A

Characteristic	Number
PRRT registrations	65
PRRT company groups paying PRRT	9
PRRT projects	24
PRRT projects involving multiple equity partners	21
PRRT projects paying PRRT	10

Note: (A) Number of PRRT registrations, projects and projects involving multiple equity partners as at 3 October 2008. Number of PRRT group companies and projects that paid PRRT in 2007–08.

Source: ANAO analysis of Tax Office information.

1.18 There was a high degree of concentration in PRRT payments; with one project providing a significant majority of all PRRT revenue in 2007–08, and five projects providing over 95 per cent of revenue. Similarly, five companies provided over 95 per cent of revenue in the same year.

²⁹ Chapter 2 examines the PRRT registration process.

1.19 Figure 1.3 illustrates the location of PRRT projects, as at October 2008.

Figure 1.3

Location of PRRT projects



Source: Map provided by Geoscience Australia.

Administration of PRRT in the Tax Office

1.20 As Australia's principal revenue agency, the Tax Office has administrative responsibility for PRRT, including for compliance issues. At a policy level, the Department of the Treasury and the Department of Resources, Energy and Tourism are jointly responsible for PRRT legislation.

1.21 The Energy and Resources Segment within the Tax Office's Large Business and International Business Line and Compliance Sub Plan has responsibility for administering the PRRT for the Tax Office. In 2007, primary responsibility for administering the PRRT was transferred from the Moonee Ponds Office in Melbourne to a PRRT unit in Northbridge, Perth.³⁰

³⁰ The Moonee Ponds team retains some PRRT responsibilities, particularly related to specific taxpayers.

1.22 Petroleum clients are generally allocated to the Northbridge team. That team has responsibility for income tax and PRRT enquiries, provision of advice and compliance activities. Unresolved technical issues are escalated and dealt with by a Senior Executive officer within the Tax Office who has extensive PRRT experience.³¹

1.23 The Energy and Resources Segment, and Tax Office more broadly, aspires to work with the community in the fair administration of the PRRT, with a business intent of 'optimising voluntary compliance under the law in a way that builds community confidence'.³²

Audit approach

Audit objective and scope

1.24 The objective of the audit was to assess the effectiveness of the Tax Office's administration of the PRRT.

1.25 The Australian National Audit Office (ANAO) identified four key areas for review. In particular, it examined whether the Tax Office had effective approaches for:

- general administration, including identification of taxable transactions, processing PRRT quarterly instalments and annual returns, and estimating annual PRRT revenue;
- PRRT compliance activities, including monitoring PRRT projects and undertaking risk reviews and audits;
- promoting certainty for taxpayers in applying the PRRT, including through interpretation and advice, litigation, and implementing recent legislative changes; and
- governance of the key elements of PRRT administration outlined above.

Audit methodology

1.26 As with other taxes, risk management is the key to the effective administration of PRRT. The ANAO examination therefore focused on how the

³¹ This Senior Executive officer is referred to as the 'Centre of Expertise for PRRT' and also has responsibility for establishing legal precedents in relation to the PRRT.

³² *PRRT Strategic Statement 2007-2011*.

Tax Office assesses and manages risks associated with the PRRT and what assurance is provided on those risks resulting from its approaches to encouraging taxpayer compliance.

1.27 The ANAO conducted fieldwork in the Tax Office's Northbridge and Moonee Ponds offices between August and November 2008. This included a review of relevant PRRT documentation and interviews with Tax Office staff from the Energy and Resources Segment.

1.28 The ANAO also consulted with a range of stakeholders including: the Australian Petroleum Production and Exploration Association (APPEA);³³ major Australian oil and gas companies;³⁴ the Department of Resources, Energy and Tourism; and the Department of the Treasury.

1.29 The audit was conducted in accordance with auditing standards at a cost to the ANAO of approximately \$220 000.

1.30 The ANAO engaged Mr Adam Allanson of Allanson Consulting Pty Ltd to provide statistical analysis and general assistance to the audit.

Acknowledgements

1.31 The ANAO appreciates the contribution of Tax Office officers, petroleum industry representatives and relevant Australian Government organisations that assisted in the conduct of the audit.

Audit report structure

1.32 The structure of the chapters reflects the audit criteria outlined in paragraph 1.25. In particular, they examine whether the Tax Office had effective approaches for:

- general administration (Chapter 2);
- compliance (Chapter 3);
- promoting certainty in administering the PRRT (Chapter 4); and
- governance arrangements (Chapter 5).

³³ APPEA is the peak national body representing Australia's oil and gas exploration and production industry. APPEA represents the collective interest of the upstream oil and gas industry in Australia. APPEA member companies produce around 98 per cent of Australia's oil and gas.

³⁴ The ANAO held discussions with 11 PRRT taxpayers or their tax agents. These companies and agents represented over 90 per cent of companies paying PRRT and of PRRT revenue in 2007–08.

2. General Administration

This chapter assesses the effectiveness of general administration of the PRRT by the Tax Office.

Introduction

2.1 Sound administrative processes and financial systems are central to ensuring that: the Tax Office collects all PRRT revenue that is due; the large individual PRRT payments (sometimes over \$200 million per quarter) are properly handled and recorded; and petroleum companies are provided with effective service.

2.2 To assess the effectiveness of general administration of the PRRT by the Tax Office, the ANAO examined arrangements put in place by the Tax Office to:

- cover all PRRT taxpayers;
- process PRRT payments;³⁵
- refund overpayments and manage debt; and
- forecast annual PRRT revenue.

Coverage of PRRT taxpayers

2.3 Given the relatively small number of potential taxpayers, tendency for projects to be undertaken as joint ventures and considerable regulation of petroleum exploration and development, there is a low risk that potential taxpayers would not be identified by the Tax Office. However, the consequences of not identifying eligible taxpayers can be high, and the audit examined this issue.

2.4 As discussed in Chapter 1, the PRRT applies to petroleum projects in offshore areas (or Commonwealth adjacent areas) under the *Offshore Petroleum Act 2006*. Commonwealth adjacent areas extend three nautical miles from the territorial sea baselines to the outer limits of the continental shelf.³⁶

³⁵ Issues relating to compliance and promoting certainty to taxpayers associated with the PRRT are discussed in Chapters 3 and 4 respectively.

³⁶ The major exclusions are production licences derived from the North West Shelf exploration permits and permits in the Joint Petroleum Development Area with East Timor.

2.5 To assess whether all petroleum projects and relevant companies were identified and registered for PRRT, the ANAO examined:

- Tax Office processes to identify and register eligible taxpayers; and
- the completeness of PRRT registrations.

Processes to register eligible PRRT taxpayers

2.6 The Tax Office provides a registration process to facilitate companies providing quarterly and annual PRRT payments. This is an administrative process (not specified in the PRRTA Act) that allows the Tax Office to allocate the client a PRRT identification number. Registration is expected upon exposure to lodge a return for the first time.³⁷

2.7 To register for PRRT, the client completes a registration form available on the Tax Office website or by request. This registration form collects information about: the company; the project; when assessable receipts are likely to be derived; and bank account details.

2.8 An officer from the PRRT Unit checks the registration forms when they are received. Once they have been approved as complete and correct, the forms are sent to the Registry Division, which creates a new Client Activity Centre (CAC) number which together with the Australian Business Number (ABN), is used as an identifier in the ATO Integrated System (AIS).³⁸ Registry then sends a confirmation to the PRRT officer in Northbridge regarding the registration, CAC Account, ABN Code and Electronic Funds Transfer Code. The PRRT officer checks this against the AIS System. The PRRT officer then sends a welcome letter to the client informing them of their registration number, Tax Office Electronic Funds Transfer Bank Account details (in which to deposit the PRRT payments) and blank instalment statements.

2.9 The ANAO considers that the registration process is streamlined and straightforward, collecting sufficient information to allow the Tax Office to

³⁷ If a participant has assessable receipts from a project subject to PRRT, the PRRTA Act requires them to lodge annual returns, and so the Tax Office provides a registration process to facilitate the annual return and payment process. The PRRTA Act also requires participants to submit quarterly instalments if they are liable to pay the tax in that quarter (because assessable receipts exceeded all deductible expenditure). It is rare for participants to submit a quarterly instalment before an annual return, so registration often occurs shortly before the first annual return is due.

³⁸ A client can have several CAC accounts, corresponding to the number of projects/joint ventures that they have registered for PRRT. An Electronic Funds Transfer code is also allocated to each PRRT registrant, in order for tax receipts and liabilities to be posted to the correct CAC Account.

effectively process annual returns and quarterly instalments. Petroleum industry stakeholders reported no problems with the registration process.

Completeness of PRRT registrations

2.10 To help ensure that all relevant projects and companies are registered for PRRT, and therefore subject to PRRT tax arrangements, the Tax Office undertakes a number of activities, including:

- reviewing Geoscience Australia's database of offshore petroleum permits and licences;
- liaising with the Department of Resources, Energy and Tourism;
- monitoring media articles; and
- examining joint venturers to determine whether all companies that are part of projects have registered for PRRT.

2.11 To test whether all relevant projects and companies were registered for PRRT, the ANAO interrogated the Geoscience Australia database of petroleum exploration and development titles, examined Department of Resources, Energy and Tourism, APPEA and State Government petroleum production databases, and undertook a general internet search. The main test was to match the participants in projects with offshore petroleum production licences³⁹ as listed by Geoscience Australia with the Tax Office's database of registered PRRT companies.

2.12 The testing aimed to provide assurance that there were no projects, or participants in projects, that were receiving assessable receipts from a petroleum project but were not registered for PRRT.

2.13 This testing found that:

- the Tax Office was aware of all 65 participants in 24 relevant offshore petroleum projects that were listed by Geoscience Australia or in State Government petroleum production databases as holders of relevant petroleum production licences; and

³⁹ To receive assessable receipts and profits from marketable petroleum products, companies must obtain a production licence. There is normally a significant delay between the granting of a production licence, actual production and first receipts.

- all 65 participants had registered for PRRT as of 21 October 2008, a number after being contacted by the Tax Office seeking their registration.

2.14 These findings indicate that the Tax Office was aware of petroleum projects that should be subject to PRRT and were taking adequate steps to ensure all relevant companies were registered.

Processing PRRT payments

2.15 From 1 July 2006 PRRT became a self-assessment tax.⁴⁰ As with other taxes, such as company tax, this requires taxpayers to submit tax payments and associated statements or returns. The onus is on the taxpayer, if requested by the Tax Office, to verify the basis for the amount of tax paid, including providing evidence of income earned and expenses incurred.

2.16 PRRT is imposed on an annual basis, and annual returns and associated payments are required within 60 days of the end of the financial year. The PRRTA Act also requires taxpayers who have a PRRT liability in relation to a petroleum project during a year of tax to pay quarterly instalments. Instalment Statements for the quarters ended September, December, and March are required to be lodged, including any instalment paid, within 21 days of the end of the quarter.⁴¹

2.17 To assess the administration of quarterly PRRT instalments and annual returns, the ANAO examined:

- the format of quarterly instalment statements and annual return statements;
- Tax Office processes to administer these statements; and
- the accuracy and timeliness of processing these statements.

⁴⁰ The move to self-assessment made little practical difference to the administration of the PRRT. While the Taxation Commissioner was previously required to assess the amount of PRRT payable for each taxing entity, there were a number of mechanisms to revise assessments, in light of new information or circumstances. Moreover, in 1991 the Deputy Commissioner of Taxation wrote to PRRT taxpayers advising that they 'were to be incorporated into the system of self-assessment currently in operation for income tax returns'.

⁴¹ The tax amount is calculated on a cumulative basis. For example, the amount of PRRT paid in the third quarter 2007–08 is calculated by determining the amount of PRRT payable over the period 1 July 2007 to 31 March 2008 and deducting any prior instalments made during that financial year.

Format of quarterly instalment and annual return statements

2.18 Quarterly instalment and annual return statements are very similar. Both capture information about the remitter and project as well as financial data relating to assessable receipts, deductible expenditure, taxable profit and the calculation of the instalment amount. The annual return statement also has a section for tax credits relating to closing-down expenditure.

2.19 The ANAO considers that quarterly instalment and annual return statements provide sufficient information to allow the Tax Office to undertake broad accuracy checks of the main elements contributing to the assessment of PRRT payable, without placing an undue administrative burden on the taxpayer.

2.20 One PRRT taxpayer commented that they would like to electronically save quarterly instalment and annual return statements downloaded from the Tax Office website <<http://www.ato.gov.au>> but this was not possible. The Tax Office advised that the issue affects all PRRT forms available online, and it is addressing the issue.⁴²

Processing quarterly instalments and annual payments

2.21 Upon receipt of quarterly instalment and annual return statements, an officer from the PRRT Unit reviews details in the statement, confirms amounts paid in previous quarters to the statement, undertakes basic mathematical checks and scans for obvious mistakes. Apart from this, there is generally little analysis of the statement.

2.22 The PRRT officer then completes a 'Posting Code' form, which is sent to the data input centre in Box Hill which inputs the data into the AIS system. The liability is keyed into the CAC Account by the operations area at Box Hill. The operations area then sends a confirmation note back to the PRRT officer to advise the information has been keyed into AIS. The PRRT officer receives a copy of the statement, and checks it to the AIS system to ensure the payment remitted by the client to the CAC account and the liability input by the operations area offset each other.

⁴² In addressing this issue, the Tax Office advised that it will consider technology matters, and the costs and benefits of allowing taxpayers to electronically save documents such as quarterly instalment and annual return statements they have downloaded from the Tax Office website.

Non-integrated PRRT financial and administrative systems

2.23 There is no integrated computer system that allows the PRRT Administrator to input data from instalment statements and annual returns,⁴³ and directly send the data to the financial management system (AIS) and the PRRT general administration system (a spreadsheet).

2.24 Providing an integrated computerised system would reduce the need for the transmission of data between two tax offices and so diminish the risk of incorrect information being input to the PRRT management database. An objective of the Tax Office's Change Program is to establish a Tax Office wide information communication technology system. This functionality is being provided by an Integrated Core Processing System (referred to as Siebel), which is now operational in the Tax Office. The PRRT Unit in Northbridge recognises the potential benefits of being fully incorporated into the core processing system. However, the PRRT Unit advised the ANAO that the integration of the separate PRRT systems into the core processing system is not a current priority for the Tax Office. Rather, PRRT systems are to be considered in *Siebel Release 3.3*, which is scheduled for deployment during 2009.

2.25 Further, the good results reported below following audit testing of the accuracy and timeliness of PRRT payment processing, support the view that integrating PRRT administrative systems does not warrant being a high priority for the Tax Office.

PRRT payment checklists

2.26 To support administration, there is a *PRRT Instalment Procedural Checklist* and a similar *PRRT Annual Return Procedural Checklist*. These single-page documents provide a useful means of helping to ensure that key processing requirements are met. For example, they require the relevant PRRT officer to record that: the appropriate payment form was used by the client; the form was lodged on time; arithmetic checks were made; and the payment made was identical to the payment advice.

⁴³ As discussed in paragraphs 2.6 to 2.8, the processing of all PRRT transactions is currently performed on a manual basis. The ABN is used as an identifier in the AIS. Payments are made by way of EFT provided to the client at the time of registration acknowledgement. All payments, refunds or amendments, are processed by way of posting which involves the creation of an offsetting entry placed in the AIS CAC account that accounts for the PRRT payment or refund. The postings are then sent to the Operations area for processing and ultimately recorded on the AIS system.

2.27 The ANAO notes, however, that these checklists have a number of items that are rarely addressed by PRRT officers (such as Default Assessment and Self Assessment categories), appear unnecessary and may detract from key checks to be made.⁴⁴ The ANAO suggests that the Tax Office reviews these checklists, with a view to removing unnecessary checking requirements and ensuring key checks are undertaken.

Accuracy and timeliness of PRRT payment processing

2.28 The audit examined the accuracy of Tax Office processing of quarterly instalments and annual returns to determine whether amounts paid by PRRT taxpayers matched amounts recorded in instalments statements and annual returns and subsequently recorded in the AIS system and relevant Tax Office spreadsheets.

2.29 The ANAO examined instalment payments and annual returns for each company making PRRT payments in 2007–08. This testing found that the Tax Office accurately processed PRRT quarterly instalments and annual returns. Of 49 annual return or instalment payments made by taxpayers, there were no instances where the amount recorded on a payment notice did not match the amount paid and recorded in the AIS system and the amount recorded in the relevant Tax Office spreadsheets.

2.30 There was evidence on Tax Office files of PRRT staff resolving problems with PRRT payments and processing, including when the client sent the payment to an incorrect account (for example, a Business Activity Statement account rather than PRRT) and rectifying miscoding of decimal points.

2.31 To support accurate augmentation of PRRT deductions by petroleum companies, the Tax Office provides a listing on its website of the long term bond rates and Gross Domestic Product factor rates applicable each year since 1980. The ANAO checked this listing in December 2008 and found it to be accurate.

⁴⁴ The ANAO examined 18 2008 PRRT annual returns and found that there was no annotation on the boxes related to self-assessment or default assessment for any return. Similarly, there was no annotation on 11 boxes relating to particulars of the form or a transfer notice for any return. This indicates either that the boxes do not refer to key information, or the checklists were not being comprehensively completed.

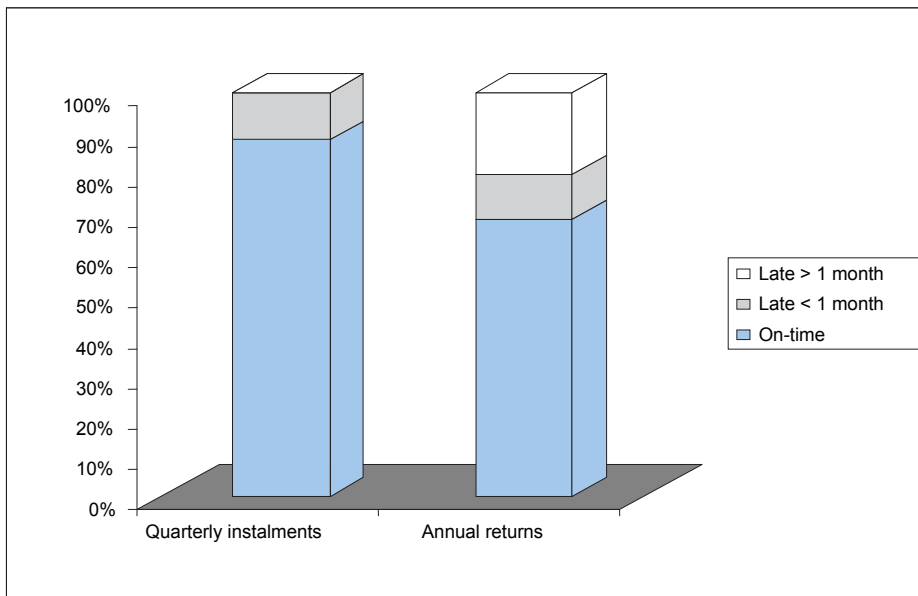
Timeliness of PRRT payments

2.32 As discussed in paragraph 2.16, the PRRTA Act requires PRRT instalments to be paid with 21 days of the end of the quarter—namely 21 October, 21 January and 21 April of each year. The annual return is to be lodged, and payment made, within 60 days of the end of the financial year (that is 28 August). Failure to pay by the due date may result in the imposition of penalties.

2.33 The ANAO tested the timeliness of payments for each client making a PRRT instalment or annual payment in 2007–08 (see Figure 2.1).

Figure 2.1

Timeliness of PRRT quarterly instalments and annual returns, 2007–08



Source: ANAO analysis of Tax Office PRRT payment data.

2.34 Over 90 per cent of quarterly instalments were paid on-time in 2007–08. Those that were not paid on-time were paid either the next working day or within a week. Therefore, there were no major administrative issues for the Tax Office to ensure the timeliness of quarterly PRRT instalments.

2.35 In the case of annual returns, more than 30 per cent were late in 2007–08, the majority of which were more than a month late. However, all but two late returns (representing three per cent of all returns) were for clients that did not pay PRRT in the year. These two returns were lodged less than 10 days late, were granted extensions, and did not pay an interest penalty. While the

Tax Office generally contacted taxpayers to remind them of requirements to promptly lodge PRRT annual returns, the performance for 2007–08 suggests that the Tax Office should continue to monitor the timeliness of annual returns to ensure the incidence of late returns does not increase, or affect more clients making PRRT payments.

2.36 Stakeholders advised of no problems with Tax Office processing of quarterly instalments and annual reports. However, a number of taxpayers noted that the requirement to make quarterly instalments within 21 days placed considerable pressure on the collection of financial information, particularly if they were not the operators of the petroleum project. In some instances they had provided ‘best guesses’ of key financial parameters and adjusted accordingly the next quarter. These taxpayers considered that being provided with a further week was likely to improve the accuracy of quarterly instalment payments. Further, a number of taxpayers would like to choose the financial year rather than it being mandated as 30 June. As many companies use a calendar year for reporting purposes, it would be administratively simpler for them if they could use the same period for providing PRRT annual reports.

Refunding PRRT over-payments and managing debt

2.37 Analysis of risks attached to the administration of PRRT suggested there was a relatively low chance of the Tax Office not refunding payments appropriately, or taxpayers defaulting on their PRRT liabilities. The audit nevertheless reviewed these issues as they are fundamental administrative processes.

Payment of refunds

2.38 Refunds are made whenever a company's payments have exceeded its tax liability. Such PRRT over-payments can arise at the end of each quarterly instalment period or at year end, if the previously calculated tax liability is reduced. A refund can also arise following a successful appeal against a disallowance, or if a loss is carried back to an earlier period.

2.39 The Tax Office does not issue refunds automatically. Generally the request for refund is taxpayer initiated which enables the AIS account to be verified prior to any refund action being undertaken. Postings to AIS will occur after a refund has been identified from either the PRRT annual return or instalment statement or from an amendment. The AIS system is continuously

monitored across the PRRT taxpayer base to ensure that if a refund is due to be paid to the taxpayer it is done so in a timely manner.

2.40 The Tax Office made nine refunds relating to PRRT instalments or returns in 2007–08, totalling over \$29 million. Audit testing indicated that all nine refunds were accurate, to the extent that they matched refunds sought by the client. All nine refunds were paid promptly by the Tax Office.

Managing PRRT debt

2.41 PRRT operates under a self-assessment regime, with an interim payment system in which there are four payment periods each year. This construction means that there is rarely any significant debt. As of 1 October 2008, there were no PRRT debt collection issues outstanding.⁴⁵

2.42 The Tax Office utilises a PRRT checklist that provides details of all currently registered PRRT taxpayers and is used as a check against the taxpayers who are required to provide instalment and return information. If instalments and returns are not lodged action is undertaken to contact the taxpayer. The ANAO observed evidence of the Tax Office making such contact, which was confirmed in discussions with petroleum companies.

Forecasting annual PRRT revenues

2.43 At various times through the year including at Budget time (in May each year), the Tax Office prepares forecasts of total annual PRRT revenue using oil price and exchange rate forecasts provided by the Department of the Treasury. The Department of the Treasury prepares its own forecasts and finalises the official forecasts in consultation with the Tax Office.⁴⁶

2.44 The ANAO examined the accuracy of PRRT revenue forecasts. Table 2.1 compares the PRRT forecasts prepared for the May Budget with the corresponding PRRT revenue outcome for the following year.⁴⁷

⁴⁵ The Commissioner of Taxation *Annual Report 2007–08* identifies PRRT taxation receivable of \$53 million. This does not relate to bad debts. Rather, due to the timing of payments and possible credit amendments there is usually a receivables and accrued revenue balance at year end.

⁴⁶ The Tax Office must also forecast PRRT revenue for the final quarter of each financial year when preparing its financial statements, as these statements are on an accrual basis, and clients have not yet submitted annual returns.

⁴⁷ These estimates were presented 13 months before the end of the financial year to which they relate, and are known as the 'original Budget estimates'.

Table 2.1**Accuracy of official forecasts of PRRT revenue, 2003–04 to 2007–08**

Financial year	Actual PRRT revenue (\$m)	Forecast (\$m)	Forecast error (%)
2003–04	1,168	1,280	9
2004–05	1,459	1,100	-33
2005–06	1,917	1,350	-42
2006–07	1,510	2,490	39
2007–08	1,686	1,890	11

Source: Commissioner of Taxation Annual Reports 2003–04 to 2007–08.

2.45 Table 2.1 shows that these PRRT revenue forecasts were often subject to large forecast errors. For example, actual PRRT revenue varied from official forecasts by over 30 per cent in three of the five years from 2003–04 to 2007–08, and the average error in forecasts over this period was 27 per cent. The actual revenue results largely reflected the volatility of oil prices, exchange rates and resource costs.

Arrangements for forecasting PRRT revenue in the Tax Office

2.46 To forecast total annual PRRT revenue, the Revenue Analysis Branch (RAB) within the Tax Office forecasts net taxable profit or loss on which the PRRT is payable for each of the oil fields registered for PRRT.

2.47 The PRRT Unit provides RAB with instalment statements, and discusses issues relevant to forecasting PRRT revenues with RAB at various times. The PRRT Unit also participates in meetings with the Revenue Management Team from the Large Business and International Business Line to discuss current and forecast PRRT revenue amounts. Representatives of RAB usually, but do not always, attend these meetings or otherwise obtain relevant advice from those meetings. In March 2009, the PRRT Unit provided RAB with detailed information to assist with the Tax Office forecast of PRRT revenue for 2009–10.

2.48 While the communication arrangements between the PRRT Unit and RAB in place at the time of audit fieldwork adequately supported Tax Office forecasts of PRRT revenue, it is important that the Tax Office reviews the appropriateness of these arrangements on a periodic basis, given the extent of volatility in actual PRRT revenues and the difficulties involved in providing accurate forecasts.

3. Compliance

This chapter examines how the Tax Office obtains assurance that taxpayers are complying with key requirements of the PRRT regime and are thereby making appropriate payments.

Introduction

3.1 Under the self-assessment regime, the Tax Office initially accepts claims made by clients and employs compliance verification and education techniques to promote and facilitate voluntary compliance with PRRT laws.

3.2 Each year, the Tax Office undertakes a program of compliance activities to validate the accuracy of PRRT payments for selected taxpayers. As part of administration of PRRT, the Energy and Resources Segment employs Tax Office/Large Business and International models, products, procedures and processes to manage the tax.

3.3 To gain a high level of assurance about the compliance of PRRT taxpayers, it is important that the Tax Office has a sound compliance planning framework based on risk management principles and practices. Operationally, Tax Office staff must have a good understanding of PRRT projects and participants. Part of the rationale for establishing a PRRT Unit in Northbridge was to develop staff with specialist knowledge of PRRT and petroleum projects. Effective compliance also requires appropriate selection of cases to review, and that those reviews are undertaken to a high standard.

3.4 To assess PRRT compliance approaches, the ANAO considered the effectiveness of efforts by the Tax Office to:

- establish and maintain a PRRT compliance framework;
- understand PRRT projects and participants;
- monitor these projects and participants, including PRRT payments; and
- undertake PRRT compliance activities.

Compliance framework

3.5 PRRT compliance activities are administered as part of the Tax Office's Compliance Sub Plan. Within this sub plan there is a clear hierarchy of compliance planning approaches, of which PRRT is a part (see Figure 3.1).

Figure 3.1

Key elements of the compliance planning framework for PRRT

Plan	Purpose	Recent coverage of PRRT
Compliance Sub Plan	Develops an annual Tax Office Compliance Program, which is reported publicly.	The <i>Compliance Program 2007–08</i> covered large business but not explicitly the Energy and Resources Segment, including the petroleum industry and PRRT.
Large Business & International (LB&I) Line Delivery Plan	Sets out the contribution LB&I will make to the Compliance Sub Plan, and provides the direction and framework for activities it will undertake during the year.	The <i>Large Business and International 2007–08 Line Delivery Plan</i> provided a strong focus on compliance, ^A including PRRT.
Energy and Resources Compliance Plan	Outlines the annual compliance programme for the Energy and Resources Segment, including the number and mix of compliance activities.	The <i>Energy and Resources Compliance Plan 2008–09</i> (p. 5) states a priority to meet ‘obligations under the PRRTA Act’. ^B
PRRT Compliance Overview	Describes the approach, broad philosophy and priorities for PRRT compliance activities.	<i>PRRT Compliance Overview 2008–09</i> outlines the objectives, values, strategies, resources and business model for administering PRRT.
PRRT Compliance Strategies	Describes key PRRT compliance strategies.	<i>2008–09 PRRT Compliance Strategies</i> outlines eight compliance strategies for PRRT. ^C
Petroleum Industry Compliance Strategy	Undertaken periodically to strengthen administration of tax issues affecting the petroleum industry.	The <i>Petroleum Industry Compliance Strategy 2007</i> (p. 4) seeks to update understanding of the petroleum industry, to identify tax risk, review internal capability and devise strategies to manage compliance.

Notes: (A) Active Compliance plus Compliance Risk Identification represented 62 per cent of funding for LB&I in 2007–08.

(B) This plan also states that the Tax Office is committed to entering into Annual Compliance Agreements with suitable taxpayers. As of November 2008, no Annual Compliance Agreements had been entered into with PRRT clients.

(C) There is also an annual PRRT Compliance Overview Statement that outlines PRRT compliance approaches within the broad PRRT strategic settings.

Source: ANAO examination of Tax Office compliance planning documents.

3.6 PRRT compliance plans form part of a cohesive line management approach, involving the Energy and Resources Segment, Large Business and International Business Line and Tax Office wide compliance planning documents and approaches.

3.7 The ANAO considers that compliance planning approaches for PRRT are consistent with, and well integrated into, broader compliance approaches in the Tax Office.

3.8 The main recent compliance planning exercises and documents for PRRT were the *Petroleum Industry Compliance Strategy 2007* and the *2008–09 PRRT Compliance Strategies*. *Petroleum Industry Compliance Strategy 2007* made seven recommendations to improve PRRT compliance activities. The *2008–09 PRRT Compliance Strategies* document adopted these recommendations (as Strategy 1) and added a further seven strategies, to be implemented as resources permitted.

3.9 The ANAO considers the *Petroleum Industry Compliance Strategy 2007* to have been a useful means of updating petroleum industry tax risks and determining compliance and related strategies for PRRT and income tax in following years.

3.10 One aspect for the Tax Office to consider in any future *Petroleum Industry Compliance Strategy* would be increasing the extent of analysis of PRRT-related information. This document had a strong emphasis on petroleum income tax analysis (for example, assessing trends in profitability and income tax paid by the main players in the petroleum industry) and so was more heavily weighted to income tax risks and treatments than indicated by the share of income tax to PRRT revenue.

3.11 The ANAO considers the *2008–09 PRRT Compliance Strategies* to be useful and comprehensive. However, there would be benefit in extending such strategies in coming years to include mechanisms for prioritisation, monitoring and reporting (see Chapter 5 for further discussion).

Understanding PRRT projects and participants

3.12 The PRRT is administered under a self-assessment regime and covers a small number of participants, with significant amounts of tax paid and complex and evolving operating conditions. In these circumstances, it is important that compliance approaches are underpinned by a thorough understanding of PRRT projects and participants and ongoing monitoring of payments and key developments. Otherwise, there is likely to be insufficient knowledge in the Tax Office for optimal case selection and to readily undertake the detailed analysis required for PRRT risk reviews and audits.

3.13 Many petroleum projects and participants have been subject to PRRT for a number of years and have had extensive reviews by the Tax Office. This is particularly the case for larger projects, such as Bass Strait, where there is considerable knowledge within the Tax Office. As a result of such activities, the Tax Office has a sound understanding of most PRRT projects and participants that have paid PRRT.

3.14 There has also been a stream of projects entering the PRRT environment in recent years, and the Tax Office has highlighted the importance of obtaining a thorough understanding of taxpayers' involvement in projects at an early stage of operations. As such there is considerable focus on the initial profile of the taxpayer to support compliance activities.⁴⁸ In this regard, the Tax Office website states that:⁴⁹

Another initiative has been an involvement and presence at an early stage of a project's operations. Undertaken in a co-operative manner, mutual benefits have been achieved for both parties as tax outcomes for certain aspects of the project were determined at an early stage in a project's life.

3.15 The focus of the Tax Office's involvement in the early stages of petroleum projects had been on major gas-to-liquids projects not yet registered for PRRT. These projects are complex and are likely to require considerable effort from the Tax Office and petroleum industry participants to reach a common view of the law.

3.16 To test the extensiveness of Tax Office knowledge of PRRT projects and participants, the ANAO considered projects registered in the past two years, to determine whether the Tax Office profiled them according to the approach outlined in the internal Tax Office document, *Compliance focus areas—Petroleum Resource Rent Tax* (LB&I).⁵⁰

3.17 The Tax Office advised that detailed profiling is generally undertaken at the point that review action is to be undertaken in respect of a participant or

⁴⁸ Tax Office internal document, *Compliance focus areas—Petroleum Resource Rent Tax* (LB&I), p. 1.

⁴⁹ Based on a paper presented to the APPEA Taxation and Finance Conference held 22-23 September 2005, available from <<http://www.ato.gov.au/large/content.asp?doc=/content/65835.htm&page=4&H4>> [accessed 17 October 2008].

⁵⁰ These represent the 13 most recently registered PRRT projects. The ANAO did not examine Tax Office profiling of the earlier 11 projects and participants as there was evidence of compliance activities that revealed a detailed understanding of most of the projects and participants.

project. As these projects had not been subject to such review, they also had not been subjected to detailed profiling.

3.18 While newly registered PRRT projects and participants may not pay PRRT for a number of years, profiling them would support effective ongoing monitoring and inform future compliance case selections.⁵¹ The extensiveness of profiling would depend on assessed compliance risks.

Ongoing monitoring of PRRT projects and payments

3.19 As discussed in Chapter 2, the Tax Office has effectively administered PRRT receipts and refunds, partly because of careful monitoring of PRRT instalment statements and annual returns.

3.20 At a reasonably aggregated level, these statements and returns provide useful information that may reveal whether payments are accurate or if there are possible anomalies.⁵² The Tax Office emphasises the importance of examining this information as part of compliance approaches. In particular, Strategy 2 of the *2008–09 PRRT Compliance Strategies* states that ‘PRRT instalments are to be monitored and analysed to address apparent inconsistencies on a real-time basis’.

3.21 There was evidence on files of the Tax Office undertaking such ongoing monitoring. Similarly, petroleum companies advised the ANAO that Tax Office staff had sometimes contacted them querying particulars of PRRT instalment statements or annual returns. These companies typically commented that such contact had been more frequent when PRRT was administered from the Moonee Ponds office prior to the transfer to Northbridge throughout 2007.

3.22 The Tax Office acknowledges this change, and advised it stems from a conscious decision that largely reflects the concomitant legal change to a self-assessment system. On this basis, the PRRT Unit in Northbridge has placed

⁵¹ This approach is consistent with an element of Strategy 3 of the *2008–09 PRRT Compliance Strategies*, which is to ‘conduct early project involvement procedures’ on registration of new clients.

⁵² Common useful checks are to compare the main components of PRRT payments (categories of assessable receipts and classes of deductible expenditure) over time for the same client or between equity partners in a project. It is also possible to examine exploration expenditure transferred from other petroleum projects held by the taxpayer or by other companies in the group, particularly if a transfer notice is attached.

greater emphasis on active compliance (risk reviews and audits)⁵³ rather than addressing potential inconsistencies on a timely basis.

3.23 While accepting this underlying approach, on the basis of file review, analysis of relevant spreadsheets and discussions with petroleum industry participants, the ANAO considers there is scope to increase the extent to which apparent inconsistencies are addressed in a timely way. This has potential benefits to both the Tax Office and taxpayers in minimising the impact of taxpayer errors.

Recommendation No.1

3.24 To better inform compliance programs and facilitate timely resolution of PRRT payment issues, the ANAO recommends that the Tax Office increases the extent to which it makes timely inquiries to resolve apparent PRRT payment anomalies, where this has significant tax liability implications for clients.

Tax Office response

3.25 *Agreed.* Since 2006 the PRRT system has operated under a legislated self assessment regime, whereby the onus is on taxpayers to voluntarily comply with the PRRT laws. While taxpayers have that primary responsibility, the Tax Office will establish risk thresholds in its current processes against which it will initiate timely inquiries to resolve apparent PRRT payment anomalies. Given the general limitation on resources the Tax Office can devote to managing various risks, such enquiries will be limited to circumstances with significant tax liability implications for clients.

Compliance activities

3.26 To assess the appropriateness of PRRT compliance activities, the ANAO examined risk management processes underpinning case selection for PRRT compliance activities, and the coverage, timeliness, thoroughness and impact of PRRT risk reviews and audits in recent years.

⁵³ The Tax Office will often place possible PRRT issues in its Healthcard risk register for consideration with other risks while framing the compliance program rather than contacting the client to clarify issues at the time the instalment notice or annual return was received.

Risk management processes underpinning case selection for PRRT compliance activities

3.27 The two main compliance activities conducted in relation to PRRT are risk reviews and audits. A risk review is typically the first step following case selection and is designed to assess whether tax risks arise from a taxpayer's self-assessment. An audit provides for an intensive examination of cases where there is a risk of material underpayment of taxation.⁵⁴

3.28 The Tax Office seeks to optimise revenue collections by allocating its compliance resources to areas identified as having the highest risk. PRRT compliance approaches are based on sound risk management processes (see Figure 3.2).

⁵⁴ Tax Office, *Large business and tax compliance*, 2006, p. 47.

Figure 3.2

Major elements of risk-based approaches to PRRT compliance activities

Element	Approach
Risk identification and assessment	Two-step approach: <ol style="list-style-type: none"> 1) involves whole of population profiling and analysis, including through a risk engine^A and incorporating specialised knowledge and broader industry intelligence; and 2) is a risk review product^B that further examines identified cases or issues.
Risk model	A key element of the risk framework is the Risk Differentiation Model, ^C and the differentiated treatment of taxpayers based on assessing the likelihood and consequence of non-compliance.
Selecting compliance activities	The <i>Petroleum Industry Compliance Strategy</i> report and <i>Compliance Strategies</i> document are used as a basis from which to evaluate compliance risks. Together with the risk engine information and in line with the Corporate Plan cases are identified and incorporated into the Petroleum Team Compliance Plan.
Governance processes	Governance process for selecting PRRT risk reviews and audits involve PRRT line structures, the Energy and Resources Compliance Risk Assessment Committee, and finally approval (or not) by the Large Business and International Business Management Committee.

Notes: (A) The risk engine examines taxpayer-reported information, data from the Australian Securities and Investments Commission and Tax Office knowledge derived from segment teams including media analysis, Industry Compliance Strategy analysis, Healthcard, various internal databases and publicly available information.

(B) These risk reviews are designed to test and refine the initial risk hypothesis resulting from the risk identification and profiling stage and determine whether any compliance issues require more in-depth investigation or response.

(C) This is a four quadrant model, comprising high risk (Q1), key clients (Q2), medium risk (Q3) and lower risk (Q4). The vast majority of PRRT taxpayers are in Quadrants 4 and 3.

Source: ANAO examination of Tax Office compliance planning documents.

3.29 These processes involve sophisticated systems for assessing potential petroleum industry and PRRT risks, but importantly also incorporate information from PRRT officers and other sources. The latter is critical for PRRT as the 'risk engine' tends to focus on income tax risks, so that information gathered from PRRT statements, returns and other sources 'on the ground' underpin case selection of compliance activities.⁵⁵

⁵⁵ Important criteria for PRRT compliance activity case selection include education, mix of tax agents, exposure to Tax Office actions, unfavourable ruling reviews, anonymous information and Energy and Resources Segment priorities.

3.30 The ANAO considers that governance processes for approving and managing compliance cases were suitable. Key elements of these processes included: broad input from appropriate personnel when considering priorities for future activity; opportunities to include emerging risks for compliance activities identified outside formal planning processes; requirements for detailed business cases; and management approval taking account of broader priorities by Energy and Resources and Large Business and International committees.

Coverage of PRRT compliance activities

3.31 The Tax Office advised that:⁵⁶

the compliance strategy for PRRT aims to provide adequate coverage of the client base. In practice this means that each of the nine company groups paying PRRT would be subject to compliance activity every 2-3 years, with additional coverage of registered PRRT companies not currently paying tax.

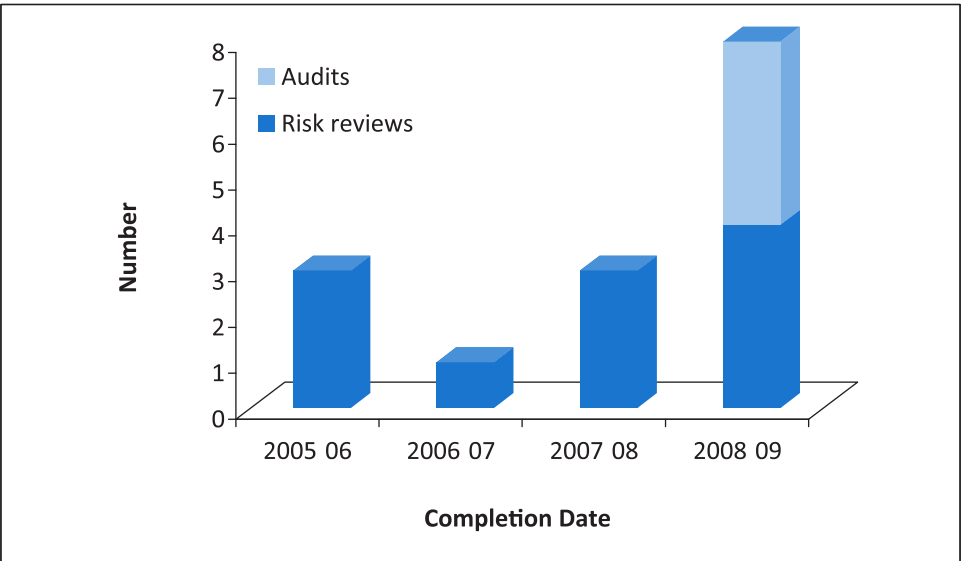
3.32 Figure 3.3 shows that there were seven PRRT risk reviews and no audits completed between 2005–06 and 2007–08. The Tax Office advised that this was typical of the level of compliance activity in most preceding years. As such, the ANAO considers that compliance activity prior to 2008–09 was generally not providing adequate coverage of the PRRT client base.

3.33 The Tax Office recognised and addressed this insufficient coverage, and the number of PRRT compliance activities completed or scheduled for completion increased dramatically in 2008–09—comprising four risk reviews or evaluations and four audits. If these activities are completed this year, this will represent reasonably complete coverage of PRRT taxpayers, in number and value, over the four years to 2008–09. Virtually all major PRRT taxpayers will be covered, as will those in the two higher-risk quadrants of the Tax Office’s Risk Differentiation Model. However, to facilitate timely identification and rectification of compliance issues, the ANAO suggests that, in future, the Tax Office seeks to maintain adequate levels of compliance activity each year.

⁵⁶ Written response from Tax Office addressing audit criteria, August 2008.

Figure 3.3

PRRT compliance activities, 2005–06 to 2008–09^A



Note: (A) Completed audit products for 2005–06 to 2007–08 and completed and scheduled products for 2008–09.

Source: ANAO examination of PRRT risk reviews, audits and audit planning documents.

3.34 As part of its future compliance risk strategies, the Tax Office will need to consider whether to undertake risk reviews on the few PRRT taxpayers not subject to such attention over the previous four years, whether to target clients not paying PRRT and how to revisit major PRRT taxpayers reviewed more recently.

Compliance activities on a project basis

3.35 Given the nature of PRRT, there are benefits in having project-based reviews for PRRT, rather than focussing on an individual equity partner. This allows a more complete understanding and coverage of a project, and also the capacity to streamline information requests to clients, especially so that the operator can provide data to support non-operator equity partners.

3.36 The Tax Office has typically undertaken compliance activities on an industry group basis, covering the various PRRT projects that major petroleum companies have participated in. However, one major PRRT project has been subject to a concurrent risk review. There have also been recent examples where the Tax Office has considered information on a project basis (for example comparing the share of assessable receipts on PRRT annual returns to

the equity shares) but then focussed on the equity partner with the highest assessed risk of having misreported.

3.37 The Tax Office has acknowledged the benefits of increasing the use of joint venture synergies to test compliance and risk assess petroleum taxation issues (Recommendation 6 of the *Petroleum Industry Compliance Strategy 2007*). Whether risk reviews are conducted for each partner in a petroleum venture will depend on the rated risks for each partner, as there is little point in subjecting a partner to a risk review if there are few identified risks for that company. Even where there are risk reviews (or other compliance activity) involving each partner in a petroleum venture, the Tax Office advised that for privacy reasons⁵⁷ it would not divulge that a partner was subject to the same review. In such instances, however, it is open to equity partners to inform each other of Tax Office attention and on this basis would have the opportunity to coordinate responses for information requested by the Tax Office.

Checking the accuracy of PRRT payments as deductions for income tax purposes

3.38 As explained in Chapter 1, PRRT is levied at a rate of 40 per cent of a project partner's taxable profit and PRRT payments are deductible for company income tax purposes.

3.39 The current company income tax return does not identify the amount being claimed as a deduction for PRRT payments. This means the Tax Office is only able to match PRRT payments and income tax deductions in risk reviews conducted as part of a compliance process. However, the Tax Office has not included this matching exercise in its program of risk reviews and audits.

3.40 The magnitude of PRRT deductions and the existence of inherent complexities have the potential to lead to significant mistakes being made by taxpayers. The ANAO therefore suggests that the Tax Office examines the accuracy of PRRT deductions for income tax purposes in future petroleum industry risk reviews. Such examination could be undertaken at least on a pilot basis to better understand the compliance risk involved.

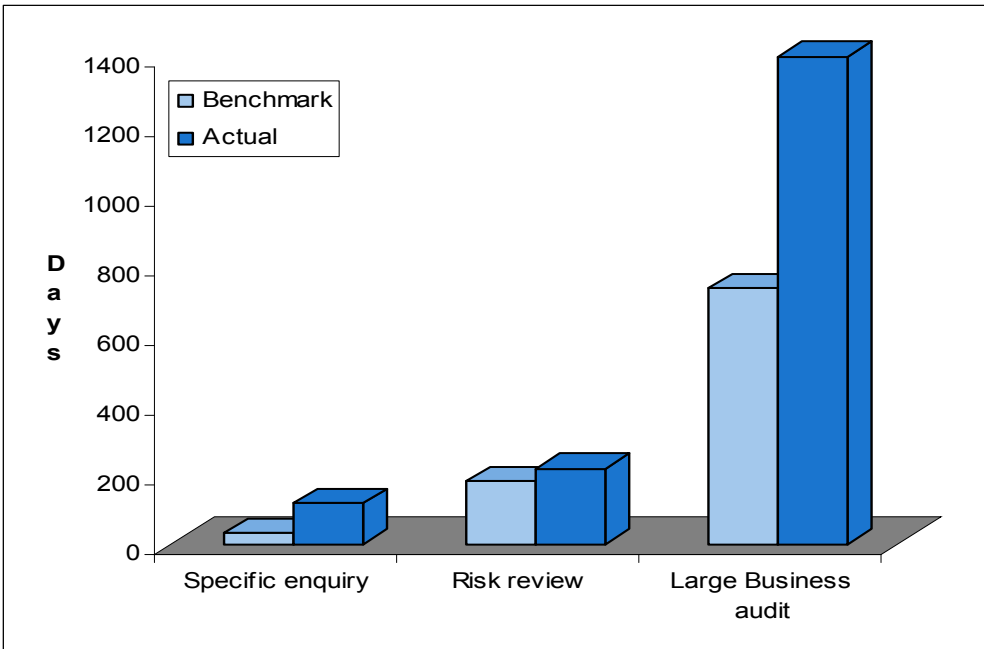
⁵⁷ Section 16 of the *Income Tax Assessment Act 1936* specifies that an officer shall not divulge any information respecting the affairs of another taxpayer.

Timing of PRRT compliance activities

3.41 Recent PRRT risk reviews were undertaken in a timely manner, only slightly exceeding the benchmark completion time of 180 days (see Figure 3.4).⁵⁸ These risk reviews were subject to effective project management arrangements. In particular, all PRRT compliance cases are incorporated into the Team Compliance Plan which is reviewed monthly to help ensure proper case management is undertaken. Monthly case management system plan reviews also assist in ensuring cases do not become aged.

Figure 3.4

Timeliness of PRRT compliance activities, 2006–07 to 2008–09^A



Note: (A) Average elapsed time taken for two completed specific enquiries, four completed risk reviews and one ongoing large business audit (as at 31 December 2008).

Source: ANAO examination of Tax Office Siebel database.

3.42 As reflected in Figure 3.4, the two specific enquiries completed in 2007 and 2008 took three to four months to complete rather than the benchmark of

⁵⁸ The benchmark time is approximately one month (30 days) to complete a specific enquiry (generally considering three or less risks), six months (180 days) to complete a specific risk review (generally considering many separate risks), and two years (730 days) for a large business audit.

one month. These were useful enquiries that identified considerable additional tax to raise in one instance, and led to an audit in the other. Given that such enquiries can be complex and require the collection and analysis of considerable amounts of information, there would be merit in the Tax Office reviewing whether the benchmark of 30 days is sufficient to complete these enquiries.

3.43 The major ongoing PRRT audit has already taken much longer than the benchmark time (of two years), and is likely to take at least twice that long to complete (four years). The extended time taken on the PRRT audit was largely due to the complexity of issues addressed and extensive information requirements to determine whether receipts and deductions were appropriate. Nevertheless, there would be merit in the Tax Office examining whether there are alternative risk approaches, information requirements and administration protocols to enable it to better meet benchmark times for such audits.

Extent to which PRRT compliance activities are soundly based

3.44 Tax Office compliance activities can be considered soundly based if, in addition to being timely, they cover relevant risks and issues, collect sufficient information, analyse it thoroughly, and have a successful outcome. To test the extent to which PRRT compliance activities were soundly based, the ANAO examined four recent risk reviews (three specific reviews and one specific evaluation) against these criteria.⁵⁹

3.45 The Tax Office advised that:

risk reviews undertaken for PRRT largely follow processes used for income tax, except that PRRT requires a thorough understanding of the petroleum project, the review of the project ring fence is compulsory, and more detailed analysis around the determination of assessable receipts and expenditure claims.⁶⁰

3.46 Each of the three specific reviews examined by the ANAO covered the key common PRRT risks, including shares of income and expenditure, taxing points, excluded and indirect expenditure, foreign exchange calculations and sale of holdings. The specific evaluation examined assessable receipts, excluded expenditure, and hedging losses. These issues were typically

⁵⁹ The ANAO did not examine the ongoing audit as it is incomplete.

⁶⁰ Written response from Tax Office addressing audit criteria, August 2008.

identified either through workshops of Tax Office experts, analysis of PRRT returns or acting on information provided by third parties.

3.47 To address these risks the Tax Office collected considerable information from clients. The ANAO considered this information to be sufficient for the Tax Office to reach conclusions about particular risks and underpin any further activity.

3.48 A number of industry participants advised that information requested for recent compliance processes was onerous, especially when they were not the operator and so it was difficult to source and provide detailed financial information, such as invoices. These participants identified a need for Tax Office discipline in limiting information requests to those directly relevant to resolving the issues in question. Taxpayer perceptions would be improved if the Tax Office provided cogent reasons for requesting information. While PRRT risk reviews are complex and typically require significant information to substantiate claims for deductions, this problem may be mitigated in the future if the Tax Office places a higher weighting on readily available sources, such as operator records,⁶¹ joint venture audits, and the control processes and general ledgers of petroleum companies. Whether these sources provide sufficient information to satisfy Tax Office enquires will depend on the quality of information available from these sources and the nature of the enquiries.

3.49 The finalised risk reports typically contained significant explanation of the analysis applied by the Tax Office to arrive at conclusions. Only one report was not clear as to outcomes and future actions for each risk assessed.⁶²

3.50 The outcomes of the four risk reviews were: collection of an additional \$2.6 million in tax in one instance; consideration of selected issues but no further action on most issues in two instances; and assurance of no material risks in the other.

3.51 PRRT compliance activities often generate revenue for the Commonwealth. For example, in 2007–08 four completed PRRT compliance activities generated tax debits of \$51 million, penalties and interest of \$6 million, notional tax of \$71 million and collections of \$36 million.

⁶¹ Operator records include monthly billing statements, monthly reconciliations and source authorisations.

⁶² The Tax Office undertook two subsequent compliance products to further assess and treat these risks.

Quality control and assurance processes

3.52 The Energy and Resources Segment has a number of processes and practices to support high quality compliance activities. For PRRT these include:

- ongoing involvement of technical leaders;
- monthly team reviews conducted with the Petroleum Director;
- monthly updates of plans on the case management system; and
- sign off requirements at the completion of each case.

3.53 In addition, business line Quality Assurance is also conducted, requiring each completed product to be peer reviewed and then quality assured prior to completion and sign off. The results of Client Feedback Questionnaires which are issued at the completion of compliance cases can also provide valuable assurance input.

3.54 The ANAO considers that these quality control and assurance processes have supported soundly based PRRT compliance products. These products have also provided a focus on timeliness, albeit some products have taken considerably longer than the benchmark duration (as discussed in paragraphs 3.41 to 3.43).

4. Promoting Certainty in Administering the PRRT

This chapter examines activities undertaken by the Tax Office to provide greater certainty to taxpayers about the application of PRRTA Act provisions.

Introduction

4.1 A tax administration that operates in accordance with the rule of law promotes certainty for taxpayers. The Tax Office's approach to applying tax law to particular facts of a case is to have regard to the words of the Act read in light of the intent of the policy and history and objects of relevant provisions. In legal terms this is referred to as a purposive approach.⁶³

4.2 There are times when, regardless of the quality of legislative drafting, words in an Act are open to be interpreted in a number of ways. To help provide certainty in such instances, the Tax Office provides interpretative assistance and advice. In relation to important matters with broad significance, the Tax Office's view of tax law is communicated through Public Rulings. To further reduce uncertainty, an individual taxpayer can seek a Private Ruling from the Tax Office in relation to an existing or proposed transaction. The Tax Office also provides interpretative assistance and advice through other avenues such as material published on its Internet site <<http://www.ato.gov.au>>, presentations to industry conferences and discussions with individual taxpayers.

4.3 Where the law is clear, the Tax Office has a duty to apply it, even if it produces unwanted outcomes for taxpayers or reduces the amount of revenue raised. For example, the law may give rise to unintended consequences, anomalies, or significant compliance costs. In such circumstances the Tax Office considers it has a responsibility to advise the Government (usually through the Department of the Treasury) of the outcome, giving it the opportunity to consider legislative change.⁶⁴

4.4 There are also times where the Tax Office and a taxpayer will disagree on the interpretation of tax law, and have the matter heard in a court or

⁶³ Tax Office, *Large business and tax compliance*, 2006, p. 10.

⁶⁴ *ibid.*, p. 10.

tribunal. There have been a number of instances of PRRT litigation, where the Tax Office is relying on the court to provide a decision on a particular case, which it potentially will then use as a precedent to be applied in similar instances (for example, the deductibility of hedging losses).

Extent of certainty in administering the PRRT

4.5 While there has been no disputation between the Tax Office and most taxpayers on most elements of the PRRTA Act, there remains uncertainty in the interpretation of a number of technical issues (see Figure 4.1).

Figure 4.1

Main PRRT technical issues requiring clarification

- Indirect expenditure, including overheads.
- Taxing point for sales gas^A (including MLMDQ^B and Take or Pay^C).
- Deductibility of hedging losses.^D
- Classification of expenditure (exploration) including Front End Engineering Design and feasibility studies.
- Application of aspects of the gas-to-liquids regulations.
- Inherited expenditure.
- Farm-ins and farm-outs (timing).^E

- Notes:
- (A) Sales gas is defined under the PRRTA Act, the principal constituent being methane.
 - (B) MLMDQ refers to the Maximum Limit of Maximum Daily Quantity. Maximum demand rather than the average demand determines the required scale of gas production, and gas wholesalers will pay a premium for a higher maximum level to meet peak demand. There is an issue as to how payments for MLMDQ are treated under the PRRTA Act.
 - (C) In Take or Pay contracts, buyers who do not take scheduled quantities are obliged to pay for them anyway. There is an issue as to how Take or Pay contracts are treated under the PRRTA Act.
 - (D) Judicial guidance, which supports the longstanding Tax Office view, has been provided by *Woodside Energy Ltd v Commissioner of Taxation* [2008].
 - (E) A joint venture or partnership where by an incoming (farm-in) partner typically earns an interest in a field by funding costs of exploration, allowing the (farm-out) partner to reduce expenditure. There is also an issue as to the timing of these arrangements under the PRRTA Act.

Source: ANAO.

4.6 Notwithstanding that the Tax Office had discussed these issues with stakeholders such as APPEA, the Department of the Treasury and taxpayers, nine of the 11 petroleum stakeholders contacted as part of this audit advised that they faced considerable uncertainty in assessing PRRT liabilities. Both the

other companies had confidence in interpreting virtually all elements of the PRRT.

4.7 Interpretation of technical issues can markedly affect the amount of tax payable, totalling hundreds of millions of dollars for some larger taxpayers over a number of years. The total amount of PRRT revenue affected by disputes is potentially over \$1 billion or around five per cent of total collections since inception.

4.8 Uncertainty in the interpretation of two issues, the classification of indirect expenditures and determining the taxing point for sales gas, has involved two of the largest PRRT taxpayers and been ongoing for each year of assessment since the early 1990s.⁶⁵ These issues are currently being negotiated or litigated, and the Tax Office has not provided detailed guidance to other PRRT taxpayers pending finalisation of decisions on these cases. There is also uncertainty over other issues listed in Figure 4.1 by one or more taxpayers.

4.9 It is important to bear in mind that while many industry representatives expressed uncertainty about similar issues (such as the deductibility of indirect expenditure), PRRT risk reviews typically identified a range of interpretation and compliance issues, which were not the same issues for many taxpayers. These findings indicated that companies were following current preferred Tax Office approaches to most of the issues listed in Figure 4.1, but were typically interpreting one or two issues differently to the Tax Office and each other.

4.10 There have also been a number of amendments to the PRTTA Act since inception, generally in response to requests from industry and after consultations involving the Tax Office, the Department of the Treasury and the Department of Resources, Energy and Tourism. These amendments have typically addressed administrative or emerging issues in the industry, rather than contentious existing issues.

4.11 Given this context, the ANAO examined the effectiveness of the Tax Office to provide greater certainty in the application of the PRRT through:

- providing interpretative assistance and advice;

⁶⁵ The taxing point dispute is more material, with hundreds of millions of dollars potentially in dispute. The indirect expenditure dispute involves far less revenue. However, if this issue is found in favour of the taxpayer or taxpayers, the length of time of the dispute is likely to mean that compound interest payable will outweigh the value of tax deduction.

- undertaking litigation;
- liaising with other Australian Government agencies to facilitate legislative amendments; and
- implementing legislative changes.

Interpretative assistance and advice

4.12 Interpretative assistance and advice is the basis for explaining and clarifying the Tax Office's interpretation of the law and giving taxpayers more certainty about taxation implications of their business activities. It is one of the Tax Office's key methods of encouraging voluntary compliance.

4.13 For LB&I, including PRRT, key mechanisms available to the Tax Office to provide interpretative assistance and advice include:

- published rulings—binding Public Rulings,⁶⁶ and non-binding rulings such as Miscellaneous Taxation Rulings⁶⁷ and ATO Interpretative Decisions (ATOIDs);⁶⁸
- Private Binding Rulings;⁶⁹ and
- other advice, including publications at public events (for PRRT this includes APPEA Conferences), information published on its website, and consultative arrangements such as workshops and other group or private advice, and one-on-one contact with taxpayers.

⁶⁶ A Public Ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes. A taxpayer will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that the ruling does not correctly state how the relevant provision applies to the taxpayer.

⁶⁷ A Miscellaneous Taxation Rulings does not rule on the application of a tax law and is, therefore, not a 'public ruling' for the purposes of Part IVAAA of the *Taxation Administration Act 1953*. It therefore does not protect the taxpayer from paying any underpaid tax, penalty or interest as does a Public Ruling.

⁶⁸ An ATOID is a summary of a decision on an interpretative issue and is indicative of the Commissioner's view on the interpretation of the law on that particular issue. In broad terms, applying an ATOID to similar circumstances can protect a taxpayer from paying penalty and interest but not underpaid tax. ATOIDs replaced Case Decision Summaries, which have been withdrawn. There were three PRRT Case Decision Summaries.

⁶⁹ The Private Binding Ruling system aims to reduce uncertainty in the law by providing protection to taxpayers who act in line with Tax Office binding advice. A Private Binding Ruling is the Tax Office's written opinion of how it will apply the income tax laws to an applicant's completed or proposed transactions. Where the Tax Office has issued a ruling that applies to a taxpayer, the taxpayer is not liable to pay more tax than the ruling requires, even if the ruling turns out to be wrong.

4.14 Figure 4.2 outlines current Public Rulings, Interpretative Decisions and other key written advice on PRRT. It shows that at the time of audit fieldwork, there were three public binding rulings, two non-binding rulings and six interpretative decisions. Taxpayers advised the ANAO that the main public document that informed them of the Tax Office's views on PRRT was a paper presented to an APPEA conference in 2005.⁷⁰

Figure 4.2

PRRT rulings, interpretative decisions and other key written advice

Date	Ruling	Subject
Current rulings^A		
4 Feb 09	TR 2009/1	Transfer of expenditure under PRRTA Act s. 45A & 45B where expenditure is incurred under s. 48 and 48A
17 Dec 08	TR 2008/10	Applying PRRTA Regulations to gas-to-liquid operations
3 Sept 08	TR 2008/6	Treatment of geo-sequestration
7 April 04	MT 2004/1	Transferring an interest in an exploration permit or retention lease
2 Dec 93	MT 93/2	Deductibility of payments made to contractors
Interpretative decisions (ATOIDs)		
May 05	2005/111 ^B	Four decisions associated with hedging or other forward contracts
May 07	2007/96 ^C	Two decisions associated with inherited expenditure
Other advice		
Various		Papers presented to APPEA conferences—particularly at 2005 Conference on major PRRT risks
Current		New Legislation Fact Sheets—available at < www.ato.gov.au >

Notes: (A) Rulings commencing with the letters 'TR' refer to public binding rulings and those commencing with 'MT' refer to non-binding rulings (see column 2). There were also two withdrawn rulings (MT 93/1W and MT 2049W).

(B) The other decisions were ATOID 2005/135, 2005/136 and 2005/137.

(C) The other decision was ATOID 2007/97.

Source: ANAO examination of Tax Office interpretative assistance and advice arrangements for PRRT.

4.15 These rulings and other written advice covered some technical issues that are subject to debate between the Tax Office and certain taxpayers—such as hedging expenses. However, a number of such issues are not addressed in

⁷⁰ APPEA Taxation and Finance Conference, 22 & 23 September 2005, *Petroleum resource rent tax—compliance and technical issues*, paper presented by Peter Bonett, Assistant Commissioner Australian Taxation Office. The contents of this paper form the bulk of the explanation of technical issues on the PRRT section of the Tax Office website <<http://www.ato.gov.au>>.

detail by the Tax Office in public documents or forums—including indirect expenditure, classification of exploration expenditure, and the timing of farm-ins and farm-outs.

Stakeholder views on interpretative assistance and advice

4.16 As discussed in Chapter 1, there are relatively few PRRT taxpayers (10 company groups), and those that pay the tax are typically large global companies, with considerable expertise in technical tax matters, or are advised by specialist tax agents. Petroleum projects are generally complex, and there is scope for alternative interpretations of many key elements of the PRRTA Act, with considerable associated financial implications.

4.17 In this environment, there is benefit in the Tax Office providing public guidance to clarify its position on key elements of the PRRT, which would improve consistency in application and reduce tax risks for petroleum companies.

4.18 Nine of the 11 industry representatives interviewed by the ANAO⁷¹ considered that the Tax Office has provided insufficient guidance to explain its position on a number of key contentious issues, including the classification of indirect expenditure and the definition of exploration expenditure. One of the remaining companies considered that there was not a great need for additional public rulings, as private advice was available and more useful as it can be tailored to the circumstances of individual companies. The other company considered that only a moderate amount of additional public guidance was required.

4.19 The nine industry representatives informed the ANAO that they were seeking a clear articulation of the Tax Office's position on many technical PRRT issues, which would include practical examples, such as those categories of expenditure that could (and could not) be included as eligible indirect expenditure.

4.20 On this basis, many industry representatives considered that after 20 years of operation the current level of uncertainty in applying the PRRT was

⁷¹ As discussed in Chapter 1, stakeholders contacted by the ANAO represented over 95 per cent of PRRT taxpayers by number and value. None of these taxpayers were rated as high compliance risks by the Tax Office.

unacceptable. These representatives noted that the level of uncertainty has led to many different interpretations of key aspects of the tax.

Recent efforts to provide interpretative assistance and advice

4.21 While the overall level remains low, the Tax Office has taken actions to increase the level of interpretative assistance and advice to PRRT taxpayers in recent times. As outlined in Figure 4.2, three PRRT Public Rulings were finalised between September 2008 and February 2009.

4.22 This increased activity addresses Recommendation 8 of the *Petroleum Industry Compliance Strategy 2007*, which was to 'market, educate and manage relationships with large business better by issuing Public Rulings on significant issues that require law clarification.'⁷²

4.23 In addition to this increased activity, a Tax Office response in May 2008 to the recommendation stated that 'subject to available resources, Public Rulings are also being considered for the following topics; exploration, taxpayer definition, and deductible expenditure'.⁷³ Further, the Tax Office issued a position paper on indirect expenditure on 18 February 2009, and has commenced action to develop a Draft Public Ruling, which it intends to issue by December 2009.

4.24 As indicated in the previous section, most petroleum industry representatives contacted as part of this audit advised that they would welcome the Tax Office providing additional Public Rulings, including on those three topics. In this regard, the Tax Office noted that it has been difficult to find common ground with some sections of the petroleum industry in providing final public rulings in some instances, including on rulings applying PRRTA Regulations to integrated gas to liquids operations (TR 2008/10) and regarding the transfer of expenditure (TR 2009/1).

⁷² Tax Office internal document, *Petroleum Industry Compliance Strategy 2007*, p. 79.

⁷³ *Petroleum Industry Compliance Strategy—May 2008 Update*, p. 6. Similarly, Strategy 5 (law clarification) of *2008–09 PRRT Compliance Strategies* is to 'market, educate and manage relationships with large business better by issuing Private Binding Rulings, Public Rulings or engage with taxpayers and their representatives to explain the Tax Office view on issues that require clarification'.

Recommendation No.2

4.25 In light of the potential to reduce uncertainty for sophisticated taxpayers in interpreting complex issues with significant revenue implications, the ANAO recommends that the Tax Office provides more extensive written guidance about key aspects of the PRRT, through additional Public Rulings and other interpretative advice.

Tax Office response

4.26 *Agreed.* Providing advice and assistance to taxpayers is a central role of the Tax Office. Last year we issued three public rulings on key aspects of the PRRT laws. In consultation with relevant stakeholders, we are currently identifying high priority PRRT technical issues to form a program of work to provide further guidance to taxpayers. This proposed program will be subject to normal Tax Office process and procedures for assessing priorities that apply to public rulings. We will continue to encourage taxpayers to request private binding rulings at any time if they want certainty as to how the PRRT law applies to their individual circumstances.

Private Binding Rulings and advice

4.27 Private Binding Rulings are one of the key mechanisms in Australia's self-assessment system to provide taxpayers with certainty of tax treatment concerning their specific circumstances. As at November 2008, only two PRRT taxpayers had entered into Private Binding Rulings with the Tax Office.⁷⁴ This reflects a lack of approaches from petroleum companies for such rulings.

4.28 The ANAO was advised that a major reason petroleum companies had not sought such rulings was that they considered it likely that such rulings would not favour them. These taxpayers considered that taking a reasonably arguable position was preferable to applying for a Private Binding Ruling.

4.29 Perceptions of Tax Office positions and behaviours influence petroleum companies' reasons for believing that Private Binding Ruling would not favour them. In this regard, some taxpayers informed the ANAO that they considered

⁷⁴ These two rulings related to the deductibility of put option premiums as selling expenses, and the deductibility of legal expenses. These were both Administratively Binding Advice provided before the legislative amendment that included PRRT in the self-assessment regime from 1 July 2006. As such, these rulings were administratively binding but not legally binding.

it likely that the Tax Office would suggest an interpretation that maximised tax revenue, and then follow through to apply such an interpretation.

4.30 These views were consistent with attitudes revealed in a comprehensive review by the Inspector-General of Taxation, who noted that ‘a perception of revenue bias tends to deter big business from making Private Binding Rulings applications unless it is necessary’.⁷⁵ The review concluded, however, that there was ‘no evidence of undue revenue bias in complex private rulings for large businesses’.⁷⁶

4.31 Irrespective of the lack of Private Binding Rulings, many taxpayers have held discussions with the Tax Office about technical PRRT issues in recent years, either after identifying themselves or on a ‘no names’ basis. These taxpayers advised that the Tax Office was professional, polite and prompt in these dealings. Reflecting the gaps in publicly provided information, these taxpayers commented that Tax Office representatives were often unable to provide advice to the level of detail sought on many key technical issues. The ANAO notes that it is not appropriate for the Tax Office to provide detailed advice without sufficient facts, which in the case of the PRRT generally requires more information and evidence than can be provided in a phone call.

4.32 In contrast to most other PRRT taxpayers, two taxpayers had extensive discussions with the Tax Office to clarify aspects of the PRRT. These taxpayers had actively approached the Tax Office for interpretations of aspects of the PRRT over the years, had generally been satisfied with the advice received, and were under little doubt as to the application of virtually all aspects of the Act. They had significantly fewer problems with the efforts of the Tax Office to provide certainty in the application of the PRRT than many other taxpayers. These two taxpayers have been subject to PRRT risk reviews in recent years, which identified no material risks.

Consultation with petroleum industry representatives

4.33 The nature of petroleum industry operations has changed considerably since the introduction of the PRRT, particularly with the greater incidence of

⁷⁵ Inspector-General of Taxation, *Review of the potential revenue bias in private binding rulings involving large complex matters* (2008), p. 27). These findings were based on a survey of views from representative large corporate applicants. Perceptions of bias in Private Binding Rulings were not limited to any particular industry group nor due to unfavourable rulings.

⁷⁶ *ibid.*, p. 3.

complex gas projects. Given the rate of change, it is critical that there is an ongoing process of engagement between all parties as interpretations of aspects of the PRRT can have a significant impact on project investment decisions.

4.34 The Tax Office identified the need to increase the level of stakeholder engagement, particularly through Recommendation 9 of the *Petroleum Industry Compliance Strategy 2007*, which proposed:

Greater engagement with taxpayers, their representatives and industry associations ... to gain greater certainty that the Tax Office view in relation to PRRT is understood and implemented correctly, particularly in relation to the gas transfer price methodology contained in the new and complex Gas Transfer Pricing Regulations.

4.35 Addressing this recommendation, recent activities of the Tax Office to engage with the petroleum industry representatives have included:

- participation in a PRRT workshop as part of the APPEA Conference in November 2007;
- an industry seminar held on 23 July 2008 at the Perth offices of Deloitte;
- a lunchtime 'meet and greet' discussion held at the Perth offices of Ernst and Young in August 2007; and
- a gas-to-liquids workshop held at the Tax Office's Northbridge site in September 2008.

4.36 Petroleum industry stakeholders informed the ANAO that they appreciated the opportunity to meet with representatives of the Tax Office to better understand its views on PRRT issues.

4.37 A view held by some stakeholders, however, was that the Tax Office could be more collaborative, and more willing to consider information and options put by industry, rather than mainly explaining a strongly preferred Tax Office position. The ANAO considers it important that the Tax Office takes these perceptions into account when developing future programs to communicate with the industry regarding the interpretation of technical PRRT issues.

4.38 There are occasions, however, where the Tax Office needs to be reasonably firm in communicating its view. This was the case at the gas-to-liquids workshop in September 2008, where the Tax Office was explaining how

it would interpret the gas-to-liquids regulations, which had recently been made as law, following extensive consultation with industry.⁷⁷

Litigation

4.39 There are many ways in which tax disputes can result in litigation. A typical scenario is that information comes to light, sometimes through a risk review or audit, and the Tax Office queries the approach taken by a taxpayer in assessing the PRRT payable. After requests for further information, where the onus is on the taxpayer to justify the position, the Tax Office makes a decision to deny a tax position (or put in place an amended assessment). The taxpayer objects to this decision, which is then dismissed by the Tax Commissioner, and the taxpayer decides to appeal to a tribunal or court (either the Administrative Appeals Tribunal or Federal Court). It is open for a taxpayer to make an offer at this (or any other stage) that the Tax Office can accept, reject or counter.

4.40 The findings of the court, after any and all appeals have been heard, provide a basis for resolving individual PRRT disputes. The Tax Office also uses judgements handed down in litigated cases to assist with interpretations of similar issues for other PRRT taxpayers and in the selection of the most appropriate compliance risks into the future.

4.41 There was relatively little litigation for the first 15 years of operation of the PRRT, but this increased markedly from around 2002. Much of the litigation has involved participants in the Bass Strait project—Esso Australia Resources Pty Ltd and BHP Billiton Ltd, who together paid a significant majority of PRRT revenue in 2007–08.

4.42 Of the 10 PRRT litigation cases listed in Figure 4.3, seven have been resolved in some way, with results mixed but mainly positive for the Taxation Commissioner (Commissioner). Three decisions were handed down in favour of the Commissioner, two disputes were withdrawn by the plaintiff (and so favoured the Commissioner) and two decisions were unfavourable to the Commissioner.

⁷⁷ Some of the comments from industry participants about more collaborative approaches from the Tax Office related to this workshop.

Figure 4.3**PRRT litigation activity**

Date	Company	Issue	Result/Status
2009	Woodside	Hedging losses (s. 24).	Favourable decision for the Commissioner.
2008	Esso	Legal Fees (s. 38&44).	Withdrawn.
2008	BHP	Time to amend (s. 64).	Withdrawn.
2008	Coogee	Hedging expenses.	Stayed pending Woodside outcome.
2008	Tap West	Hedging expenses.	Stayed pending Woodside.
2007	Esso	Extension of time to lodge objections.	Favourable decision from the Administrative Appeals Tribunal for the Commissioner.
2006	Woodside	Hedging losses (s. 24).	Favourable decision for the Commissioner.
2004	Esso and BHP	Taxing Point Litigation—Taxing Point, MLMDQ and Take or Pay.	Appeal to Federal Court in 2004. No hearing as yet.
2004	BHP	Combine a project	Decision by Federal Court unfavourable to the Commissioner.
2002	Esso and BHP	'Pass-on' dispute concerning time receipts from some customers were derived.	<ul style="list-style-type: none"> Decision by Federal Court in March 02. Decision by Full Federal Court (on appeal) in December 2002. That decision was unfavourable to the Commissioner.

Source: ANAO examination of Tax Office litigation activity regarding PRRT.

4.43 Matters currently being litigated include taxing point issues disputed by BHP Billiton Ltd and Esso Australia Resources Pty Ltd, still to be heard by the Federal Court. The Tax Office view in respect of hedging losses was supported by the Full Federal Court decision in relation to Woodside Petroleum Ltd, released in February 2009.

Effects of litigation

4.44 As discussed in paragraph 4.39, litigation is the final phase in resolving issues where a taxpayer continues to dispute Tax Office assessments, and seeks to have the matter decided in court. In this way, litigation generally results in the resolution of disputes.

4.45 Petroleum industry representatives, including those not involved in litigating PRRT matters, highlighted that litigation is time consuming and expensive and, once underway, has stifled more expedient solutions. Some of these stakeholders noted that the Tax Office is often unwilling to provide advice when awaiting a court ruling, which leaves the industry with undesirable levels of uncertainty. This is an escalating problem as the number

of PRRT taxpayers has increased in recent years, with many of these companies relatively small or of medium size.

4.46 The ANAO notes that litigation or ongoing negotiation with individual taxpayers surrounding two PRRT issues, taxing points and indirect expenditure, has resulted in many years of uncertainty for taxpayers, and the issues are yet to be resolved. The Tax Office has provided little detailed public advice on these issues in the interim. As discussed in paragraph 4.23, the Tax Office has issued a position paper on indirect PRRT expenditures and commenced action to develop a Draft Public Ruling on the topic.

Different approaches to interpreting the intent of the PRRTA Act

4.47 Fundamentally, litigation has arisen because of differences in interpretation of the PRRTA Act between the Tax Office and individual taxpayers. A key reason for these different interpretations was the contrasting attitudes of the Tax Office and some PRRT taxpayers to interpreting the underlying intent of the PRRTA Act.

4.48 Many PRRT taxpayers had concerns that when applying a purposive approach the Tax Office placed an undue emphasis on ‘ensuring that the Australian community receives an appropriate share of economic returns from petroleum deposits’, and did not sufficiently consider ‘whether companies were being provided with adequate rewards in return for risks they accept in undertaking offshore exploration and development’.⁷⁸

4.49 Some petroleum industry representatives considered that this situation has arisen because the purposive approach taken by the Tax Office reflects its income tax methodologies and is not as suited to interpreting the policy intent of an economic tax such as the PRRT.

4.50 When addressing the Tax Office’s application of the purposive approach to Private Binding Rulings, the Inspector-General of Taxation noted that taxpayers sometimes considered that ‘an alternative construction was more congruent with the text of the legislative provisions and its publicly available extrinsic materials’.⁷⁹ In this regard, an issue for the interpretation of the PRRTA Act is a lack of available extrinsic materials. In particular, the explanatory memorandum to the PRRTA Act in 1987 was silent on most of the

⁷⁸ This is the policy intent of the PRRT, as described on the Tax Office website <<http://www.ato.gov.au>>.

⁷⁹ Inspector-General of Taxation, op. cit., p. 5.

issues currently in dispute (for example, taxing points for sales gas, take or pay, indirect expenses and hedging).

4.51 Given the absence of relevant extrinsic materials, much of the disputation on technical PRRT issues is based on Tax Office interpretations of the text of the PRRTA Act, given its understanding of the policy, that are not necessarily the most apparent on a reading of the text,⁸⁰ and that are inconsistent with the taxpayer's understanding of the underlying purpose of the Act.

Perceptions of pro-revenue bias in administering the PRRT

4.52 In disputes about technical PRRT issues, the Tax Office and petroleum companies have sometimes simply 'agreed to disagree' on PRRT interpretations and have the matter decided by a court. However, one company in litigation with the Tax Office over PRRT, and a number of other petroleum industry stakeholders, perceive that the Tax Office has a general pro-revenue bias when administering the PRRT.

4.53 As indicated earlier with respect to Private Binding Rulings (see paragraphs 4.28 to 4.30), perceptions of pro-revenue bias are common amongst big business generally, but were not substantiated in a review by the Inspector-General of Taxation. Consistent with this finding, a limited review of Tax Office files by the ANAO did not identify evidence that would substantiate claims of a general pro-revenue bias by the Tax Office when administering the PRRT.

4.54 The main reason suggested by the Inspector-General for a perception of pro-revenue bias is relevant to petroleum companies paying PRRT. That is, a lack of transparency in disclosing the full circumstances and reasons for interpreting key elements of tax law leaves taxpayers little to go on but their own views of what may be happening.

4.55 The Tax Office is taking steps to improve transparency in interpreting the PRRTA Act by increasing the extensiveness of public rulings and other advice, and increasing communication with taxpayers to determine positions on emerging issues such as gas-to-liquids. However, as proposed in Recommendation No. 1, there is scope for the Tax Office to further improve the extent and effectiveness of these activities.

⁸⁰ A purposive interpretation need not be the most apparent one on a reading of the text of the law.

4.56 The way in which the Tax Office conducts litigation and its enhanced program of PRRT compliance risk reviews and audits will also have a strong bearing on perceptions of revenue bias, and broader perceptions of professionalism, by PRRT taxpayers. A key factor will be transparency and clarity in the explanation of reasons why the Tax Office disagrees with taxpayer positions, including a detailed statement of the Tax Office position wherever possible. The consistency of approaches taken by the Tax Office, to similar technical PRRT issues and across taxpayers, will also strongly influence perceptions of bias.⁸¹

4.57 Any reduction in perceptions of pro-revenue bias is likely to lead to an increase in the number of Private Bindings Rulings sought, which would also support greater certainty in the administration of the PRRT. The recent increase in the number of risk reviews and audits may also be a factor in this regard. If a significant number of compliance breaches are identified, this would increase the incentive for companies to agree positions, rather than rely on apparently defensible positions that are subsequently disallowed.

Liaising with other Australian Government agencies to facilitate legislative amendments

4.58 Given the extensive time taken, resource costs and levels of ongoing uncertainty in resolving technical PRRT issues, petroleum industry stakeholders suggested alternatives to current approaches based around the application of Tax Office dispute mechanisms and ultimately litigation. As previously discussed, two approaches with the potential to mitigate the need for litigation are greater provision of public advice and more detailed advice in individual cases about Tax Office positions.

4.59 Many petroleum industry stakeholders consider it critical, where practicable, to resolve PRRT technical issues through legislative amendments. This requires discussions between the Tax Office, industry representatives, and the relevant Australian Government policy agency—the Department of the Treasury (Treasury) and possibly the Department of Resources, Energy and

⁸¹ In 2006 one taxpayer sent a letter to the Inspector General of Taxation alleging that the Tax Office had breached the 'model litigant' principle, claiming that the Tax Office held inconsistent positions on the PRRT law in the hedging litigation to that held in certain aspects of the MLMDQ matter (Maximum Limit of the Maximum Daily Quantity). The complaint was referred to the Office of Legal Services Coordination in the Attorney-General's Department, which found that there had been no breach on the part of the Tax Office.

Tourism (RET), who have a role in bringing these issues to the attention of the Government.⁸²

4.60 Petroleum stakeholders also consider that the changing nature of the industry's operations necessitates dialogue on how the legislation should be best modified to address ongoing disputes, as well as new commercial and technical parameters.⁸³

4.61 In this broader regard, six of the 11 petroleum industry stakeholders participating in the audit considered the PRRTA Act required moderate revision to resolve existing and emerging issues, three representatives considered it required substantial redrafting, while representatives of two major petroleum companies considered it to be extremely workable.⁸⁴

4.62 As indicated in Chapter 1 and paragraph 4.10, the Tax Office has worked with Treasury and RET to implement a number of changes to the PRRTA Act since its enactment, although these have typically not involved issues in dispute with taxpayers.

4.63 A fundamental consideration for the Tax Office when assessing whether to involve Treasury in discussions about potential legislative solutions to PRRT taxpayer disputes is whether it considers itself unable to administer the law in a manner that gives effect to the purpose of the PRRTA Act. That is, whether or not it is confident in applying a purposive approach to the legislation.

4.64 In its treatment of the main PRRT issues in dispute, the Tax Office has considered itself able to administer the law in a manner that gives effect to the purpose of the legislation.⁸⁵ Further, it has considered that these technical issues can't be resolved through legislative change and therefore has not

⁸² As discussed in paragraph 4.3, the Tax Office considers that it has a responsibility to advise the Government where existing laws have adverse consequences and there are benefits from giving it the opportunity to consider legislative change.

⁸³ APPEA submission to the Tax Design Review Project regarding PRRT, 14 February 2008.

⁸⁴ Those representatives that identified benefits from moderate or substantial revision of the PRRTA Act emphasised the changing nature of the petroleum industry since the enactment of the PRRTA Act, especially for the gas industry and associated definitions of taxing points and marketable petroleum products.

⁸⁵ It is self-evident that individual taxpayers disagree the Tax Office is giving proper effect to the purpose of the legislation, as that is the cause of disputes that lead to litigation.

invoked formal interagency processes for communication with Treasury on the potential implications of its view of the PRRT.⁸⁶

4.65 While not invoking formal interagency processes, the Tax Office has recognised there are significant implications of its PRRT interpretations and have sometimes drawn them to the attention of the Treasury through discussions that are not part of defined processes for considering legislative amendment.

4.66 Representatives of the petroleum industry typically supported Treasury and RET having a role in providing advice on technical PRRT issues including on matters in dispute with the Tax Office. To this end, representatives of the petroleum industry have separately informed Treasury and RET of many, but not all, PRRT issues in dispute. PRRT taxpayers are aware that these agencies understand the nature of the main disputes. However, these taxpayers are generally not aware of the frequency or nature of such communication between the Tax Office and either Treasury or RET.

4.67 The Tax Office has identified scope to improve the extent of collaboration with other government agencies concerning PRRT. Recommendation 3 of the *Petroleum Industry Compliance Strategy 2007* was to:

Work with key partners in the Tax Office and other government departments in a whole of government approach. Facilitate an in-house Petroleum Conference with key partners in the Tax Office, and other government departments, in order to share our petroleum industry knowledge and ensure consistency in treatment of legislative and administrative issues of law for which we are responsible.

4.68 At the time of audit fieldwork, the proposal to facilitate an in-house Petroleum Conference in Moonee Ponds had been indefinitely postponed due to budgetary constraints. While the PRRT Unit continued to liaise and work with key partners in the Tax Office and other government departments, there is an opportunity to improve the extent of consultation between the Tax Office, Treasury and RET regarding legislative and administrative issues relating to the PRRT.

⁸⁶ These formal interagency processes are set out in Law Administration Practice Statement, *PS CM 2003/14*, 9 May 2003. It states that 'in cases where the Tax Office is making a specific recommendation to change a policy approach or law design, it is highly desirable that the Tax Office advice is comprehensive. In such cases the Tax Office will provide a full assessment of all the impacts and this advice should be expressed in the form of an Administrative Impact Statement.'

4.69 Seizing this opportunity will better meet the preferred approach of the Joint Committee of Public Accounts and Audit (JCPAA), which ‘is for Treasury, Government and stakeholders to work together to develop clear, simple tax policy. This should result in clearer and simpler tax legislation and tax administration’.⁸⁷

4.70 Advising industry of the existence of such activity, and the key issues being discussed, is likely to improve perceptions by the petroleum industry that the Australian Government is taking a suitably coordinated approach to administering the PRRT.

4.71 The ANAO suggests, therefore, that to improve the extent of collaboration with other government agencies concerning PRRT, the Tax Office implements Recommendation 3 of the *Petroleum Industry Compliance Strategy 2007*.

Administering litigation and technical PRRT issues

4.72 The Energy and Resources Segment has addressed escalation processes dealing with technical PRRT issues, including the Public Rulings program and litigation, by establishing a Centre for Expertise for PRRT. At the commencement of audit fieldwork, this centre comprised one person, a senior lawyer who was part of the Tax Counsel Network.

4.73 At that time, this resourcing level was unchanged since it was identified as a risk in the *Petroleum Industry Compliance Strategy 2007*, which noted that the increase in litigation has placed considerable strains on the Tax Office Tax Counsel Network. The report further stated that:⁸⁸

Several large litigation cases are expected in relation to petroleum entities. This will make demands on our FTE in general, and will make specific demands on our ability to provide staff who have the skills and confidence to take on complex work to support the litigation, over a protracted period of time.

4.74 The Tax Office subsequently advised that work is being allocated to spread depth of technical experience of technical PRRT issues within the Tax Counsel Network and further allocations are meant to provide a larger pool of

⁸⁷ JCPAA 2008, *Report 410 Tax Administration*, p. x.

⁸⁸ Tax Office internal document, *Petroleum Industry Compliance Strategy 2007*, p. 67.

experienced officers so that resource constraints on dealing with such issues will be eased.

4.75 Given past strains on resourcing PRRT through the Tax Counsel Network, and the prospect of future increases in workload, the ANAO considers it important that the Tax Office allocates an adequate level of resourcing for the PRRT Centre of Expertise. While resource requirements will depend on the scale of the future technical PRRT programme, it is likely that the increase in staffing would be in the magnitude of contributions from two additional senior lawyers to supplement the existing officer.

Recommendation No.3

4.76 To enable timely and cost-effective resolution of technical PRRT issues, the ANAO recommends that the Tax Office strengthens the capacity of the PRRT Centre of Expertise by allocating sufficient time of additional senior lawyers from the Tax Counsel Network to adequately supplement the existing officer.

Tax Office response

4.77 *Agreed.* The Tax Office is currently reviewing its level of Tax Counsel Network PRRT technical support. Additional Tax Counsel Network resources will be allocated on a needs basis to support the timely resolution of PRRT precedential technical issues.

Implementing legislative changes

4.78 As outlined in Chapter 1, there have been many changes to the PRRTA Act since its inception.

4.79 Stakeholders informed the ANAO that changes to the PRRTA Act have generally streamlined administration and reduced compliance costs, and that the Tax Office has implemented them effectively.

4.80 To form an opinion in relation to how well the Tax Office has implemented legislative change, the ANAO examined the Tax Office's implementation of seven major amendments to the PRRT which became effective from 1 July 2006 (see Figure 4.5).

Figure 4.5**Amendments to the PRRTA Act effective 1 July 2006**

The seven major amendments to the PRRT which became effective from 1 July 2006 were to:

- allow the deduction of transferable exploration expenditure when calculating quarterly instalments;
- allow the deduction of closing-down costs when moving from a production to an infrastructure license;
- allow taxpayers to self assess their PRRT liability;
- provide roll-over relief for internal corporate restructuring;
- allow the deduction of FBT for PRRT purposes;
- introduce a transfer notice requirement for vendors disposing of an interest in a petroleum project; and
- extend the lodgement period for PRRT annual returns from 42 to 60 days.

Source: ANAO examination of the PRRTA Act.

4.81 To implement these legislative amendments, the Tax Office undertook a number of actions, including:

- issuing fact sheets to stakeholders to advise of the changes;
- issuing call centre staff with a script to help ensure they referred any phone enquiries about the amendments to PRRT staff, who had been trained to provide appropriate responses;
- updating the PRRT website, although it has not been fully updated to reflect these changes;⁸⁹
- developing a Policy Implementation Forum document, which refers to a number of procedures to be adopted in relation to internal education, skilling and communication;⁹⁰ and
- updating relevant PRRT forms.

4.82 As the measures were initiated by industry, there was minimal requirement for external education.

⁸⁹ The main guidance to be updated is the deduction of closing down expenditure at the time when a production licence is converted to an infrastructure licence (even though these costs are incurred at the end of the infrastructure licence). However, the *PRRT: overview* and *PRRT: compliance and technical issues* sections state that 'expenditure in closing down a project is deductible in the year it is incurred'.

⁹⁰ This document also refers to procedures to be adopted to ensure compliance with the legislative amendments, by way of revenue monitoring and intelligence gathering and treatment of that intelligence.

4.83 The ANAO considers that the Tax Office effectively implemented the seven major amendments to the PRRT which became effective from 1 July 2006.

5. Governance Arrangements

This chapter examines governance arrangements underpinning the Tax Office's administration of the PRRT.

Introduction

5.1 Governance refers to the processes by which organisations are directed, controlled and held to account. It encompasses authority, accountability, stewardship, leadership, direction and control exercised in the organisation. Public sector governance is explained in the ANAO's Better Practice Guide, *Public Sector Governance*.⁹¹

5.2 To assess the effectiveness of the Tax Office's governance arrangements supporting the administration of the PRRT, the ANAO examined three key issues:

- organisational arrangements for administering PRRT;
- planning processes; and
- performance monitoring and reporting.

Organisational arrangements

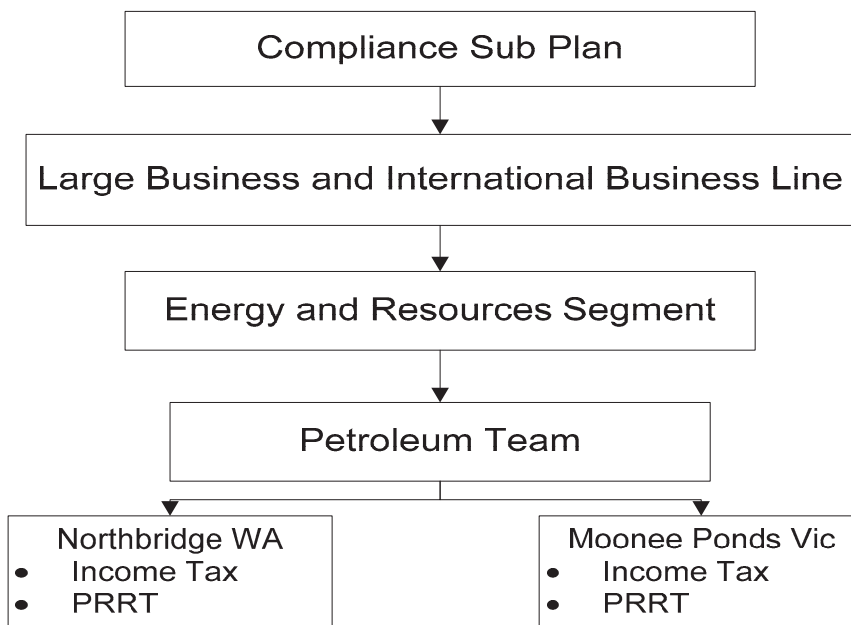
5.3 The Tax Office is a large organisation consisting of 23 303 staff as at 30 June 2008. To administer the taxation system and effectively address business and compliance risks, the Tax Office has adopted a matrix management model. The model combines the key elements of the Tax Office's management and planning frameworks. As part of its management framework the Tax Office classifies market segments and special focus areas to assist with risk identification, and organisational and business planning. The business and service lines are responsible for achieving the Tax Office's outcome and output commitments to Government.

5.4 The Energy and Resources Segment within the Large Business and International Business Line and Compliance Sub Plan has prime carriage for managing PRRT compliance risks. A view of PRRT's functional structure at the time of audit fieldwork is shown in Figure 5.1.

⁹¹ ANAO Better Practice Guide—*Public Sector Governance*, Volume 1, July 2003, Canberra, p. 6.

Figure 5.1

Core structure for administering PRRT in the Tax Office



Source: ANAO analysis of Tax Office information.

5.5 Forming part of Energy and Resources Segment is the Petroleum Team. This team is led by a Director in Northbridge, Western Australia and contains 12 staff in total, all of whom have some responsibility for administering PRRT. Each staff member has responsibility for income tax and PRRT enquiries, providing advice, and compliance activities relating to particular clients.⁹²

5.6 Staff at various levels in the Moonee Ponds office in Melbourne are actively involved in PRRT issues in respect of two major PRRT clients, who have their primary activities and head office located in Melbourne. In addition, an experienced senior executive officer in Canberra who is part of the Tax Counsel Network (designated the 'Centre of Expertise for PRRT') has been given responsibility for providing timely advice and public rulings in relation to significant PRRT technical issues.

5.7 There have been significant changes to PRRT administrative structures since 2007, to improve overall administration and provide better service to

⁹² One officer is responsible for the maintenance of the client registrations, instalment and return processing and information management.

clients. The two major changes were the move of PRRT administration from Moonee Ponds to Northbridge⁹³ and the establishment of the Centre of Expertise for PRRT.

5.8 Strengths of current administrative structures for PRRT include: clear lines of responsibility through to the Tax Commissioner; alignment of PRRT and company tax within a petroleum unit facilitating synergistic use of expertise; and the use of client managers enhancing project expertise and stakeholder negotiation.

5.9 The two office approach reflects the geographic distribution of petroleum projects, with a focus on the petroleum growth area in Western Australia, and retaining a local presence for Victorian producers. As yet, however, there has been insufficient time and information to determine the success of this approach (see paragraphs 5.36 to 5.40).

5.10 Stakeholders generally were satisfied with PRRT administrative structures.

PRRT resourcing and skilling risks

5.11 The Tax Office's *Petroleum Industry Compliance Strategy 2007* (PICS 2007) identified a range of risks associated with the resourcing and skilling of PRRT and related activities. It stated that:

In recognition that compliance issues relating to Petroleum and PRRT have not been adequately resourced, [Energy and Resources Segment] has implemented strategies to boost the number of staff to address them... However some capability risks persist, in the areas of PRRT, Litigation, Staff Profile, Skilling and Intelligence.

5.12 Figure 5.2 outlines capability risks outlined in PICS 2007 and the current status of these risks.⁹⁴

⁹³ The Tax Office's management of all PRRT nationally was moved from the Moonee Ponds office in Victoria to the Northbridge office in Western Australia throughout 2007, in recognition of the greater number of PRRT projects and participating companies in Western Australia.

⁹⁴ The Tax Office does not have a formal risk-management approach to monitoring these risks, including treatments, and rating residual risk levels on an annual ongoing basis.

Figure 5.2

PRRT capability risks

Risk	Issue	Current status
Inadequate capability around PRRT	Energy and Resources Segment has lost significant expertise in PRRT. PRRT casework outside Victoria may suffer from capability issues	Addressed through move to Northbridge, although some shortfalls persist.
Litigation	Not being able to support a demanding litigation program	Require additional experienced staff to lead and support litigation cases.
Staff profile	Not having staff at right classification to do growing volume of complex work	Resourcing has been reviewed and staffing classification slightly increased.
Staff numbers	Not having enough staff working on PRRT issues	Overall staff numbers have increased from around 10 in 2005 to 12 in late 2008. Current levels are broadly appropriate.
Skilling	Inadequate skilling and development	Potential benefit in reviewing skilling arrangements and guidance documentation.
Lack of integration of intelligence function	Current disconnect between E&R's intelligence function and the risk identification function	Strengthening monitoring of PRRT projects and payments would help.
Succession planning	Loss of experienced staff	Large Business and International has identified hot-spots and required segments plans to address them.

Source: ANAO examination of *Petroleum Industry Compliance Strategy 2007* and subsequent actions.

5.13 Recent action taken by the Tax Office associated with the move of PRRT administration to Northbridge, and findings of the audit, suggest that the PRRT capability risks identified in PICS 2007 have been partially addressed.

5.14 Skilling and resourcing is generally sufficient for core PRRT administration and undertaking compliance activities. However, there is scope for minor changes to resourcing. As discussed in Chapter 4, while steps have been taken to increase resourcing for PRRT technical advice and support for litigation cases, it is important that there is a firm commitment to, and planning of, sufficient resourcing for these activities.

PRRT skilling

5.15 PICS 2007 noted that several systemic problems regarding skilling have existed in the Large Business and International Business Line (LB&I) since inception. These problems apply to PRRT, and mainly relate to the specialised

nature of the work and small number of positions involved. As a result, at any given time, it is generally difficult to assemble the numbers to justify formal training.⁹⁵

5.16 The PICS 2007 report also found there had not been a strong investment in PRRT skilling and training.⁹⁶ Nor was there an entrenched administrative system which incorporated practices such as conducting regular LB&I-wide training needs analysis, planning skilling on the basis of such results, linking a training program to a planned work program and publishing national skilling programs well in advance.

5.17 Subsequent to the PICS 2007 report, LB&I has developed an integrated capability development framework that aims to ‘build, develop and sustain and LB&I professional workforce that can operate effectively in the highly technical and sophisticated large market.’⁹⁷ Strategy 3 of this framework is to continue to build a skilling and development program for LB&I’s workforce.

5.18 With respect to PRRT, the way the Energy and Resources Segment has managed skilling in this context has been:

- formal training provided by Moonee Ponds Office upon handover to Northbridge and subsequently on a limited basis;
- a training needs analysis;
- induction courses and active compliance program courses;
- through on-the-job training during discussions of live issues;
- workshops, phone hook-ups and email exchanges with the Tax Counsel Network; and
- peer reviewing provided by Moonee Ponds Office as required.

5.19 Two main documents are available to inform staff of key elements of PRRT administration—*PRRT Skilling and Reference Guide* and *Compliance focus areas-Petroleum Resource Rent Tax (LB&I)*. The ANAO considers that these documents provide useful policy and guidance information for new starters. However, they are both a number of years old, have not incorporated recent

⁹⁵ Tax Office internal document, *Petroleum Industry Compliance Strategy 2007*, p. 68.

⁹⁶ *ibid.*, p. 69.

⁹⁷ Tax Office internal document, *LB&I Integrated Capability Development Framework 2008–09*, p. 1.

changes to the PRRTA Act and administrative arrangements, and therefore would benefit from review and updating. The Tax Office advised that it has commenced projects to update these two documents.

5.20 ANAO fieldwork and views of stakeholders indicate that skilling levels are generally high for PRRT administration, and have been improving in Northbridge as staff gain experience following the establishment of the PRRT Unit in 2007.

Planning processes

5.21 A sound organisational planning framework is an essential element of effective management and governance. The Tax Office's high level planning documents, particularly the Outcome and Outputs Framework,⁹⁸ Strategic Statement,⁹⁹ and Corporate Plan,¹⁰⁰ set the overall direction for the organisation.

5.22 PRRT compliance activities are administered as part of the Tax Office's Compliance Sub Plan. As discussed in Chapter 2, within this sub plan there is a clear hierarchy of compliance planning approaches, of which PRRT is a part. PICS 2007 identified current and emerging tax risks, reviewed internal capability in relation to that risk and devised strategies to manage compliance. The *E&R Compliance Management Plan 2008/09* identifies the taxpayer and products to be applied to each taxpayer to be undertaken to June 2009.

5.23 To determine whether PRRT planning was integrated and cohesive, the ANAO examined the content of and linkages between the PRRT Compliance Strategies and various higher level plans outlined above.

5.24 The PRRT strategic planning documentation was well integrated into the Tax Office's broader planning framework. However, there is scope to extend the PRRT planning framework.

5.25 As discussed in Chapter 3, *2008–09 PRRT Compliance Strategies* establishes strategies that underpin the Tax Office's approach to compliance

⁹⁸ The Outcomes and Outputs framework establishes the Tax Office's corporate direction, impacts to be achieved and specifies the products and services it has undertaken to deliver to the community.

⁹⁹ The Strategic Statement provides direction and a framework for the Tax Office's activities over a three-year period.

¹⁰⁰ Collectively the Tax Office's five sub-plans form the *ATO Corporate Plan*. The Tax Office's sub-plans articulate the strategies, priorities, risks and performance measures it uses to manage performance in relation to outcomes to be achieved and outputs to be produced.

and interpretative assistance and advice regarding PRRT. The document was first prepared in 2008–09, and represented an important initiative to guide the administration of PRRT by the Tax Office at the working level.

5.26 The *2008–09 PRRT Compliance Strategies* document is a three-page listing of strategies that states: ‘to the extent resources permit, the 2008–09 PRRT Compliance Strategies are as follows’. There is no further discussion of resourcing, the relative importance and prioritisation of strategies or how the strategies will contribute to PRRT and associated objectives—no performance indicators are attached or referred to. While the Tax Office monitors and reports against many of the strategies in other documents,¹⁰¹ there is no process to expressly gauge progress in implementing *2008–09 PRRT Compliance Strategies*.

5.27 Extending annual *PRRT Compliance Strategies* to include performance indicators, and expressly monitoring performance against these indicators, would allow the Tax Office to gauge its success in implementing key PRRT strategies, and support continual improvement in performance.

Recommendation No.4

5.28 To complete the planning framework for PRRT and support continual improvement in administration, the ANAO recommends that the Tax Office extends the approach taken in *2008–09 PRRT Compliance Strategies* to develop, monitor and report against key performance indicators for each recommended strategy.

Tax Office response

5.29 *Agreed in part.* The Tax Office will examine the feasibility of further developing, monitoring and reporting against key performance indicators for its PRRT compliance strategies. Resource and system constraints, as well as the need to ensure consistency in reporting, require that any development is within current systems and reporting frameworks.

¹⁰¹ For example, in documents discussed at bi-monthly Energy & Resources Executive Meetings, such as Interpretative Assistance reports and Compliance reports.

Performance monitoring and reporting

5.30 Performance management underpins sound management and governance. Ongoing and regular monitoring and reporting of performance supports agencies in managing programs and in meeting external accountabilities to the Government and to the Parliament. The timely collection, and regular analysis and reporting of relevant performance information, assists in more effective decisions about the ongoing resourcing and impact of PRRT compliance activities.

5.31 The ANAO examined external and internal reporting of PRRT performance.

External reporting of performance

5.32 The Tax Office utilises a variety of forums to report on PRRT activities including its annual report, specific publications, media releases, Internet, and speeches.

Tax Office annual reporting

5.33 Section 16(1) of the PRRTA Act states that:

- (1) The Commissioner shall, as soon as practicable after 30 June in each year, prepare and furnish to the Minister a report on the working of this Act, including any breaches or evasions of this Act of which the Commissioner has notice.
- (2) The Minister shall cause a copy of a report furnished under subsection (1) to be laid before each House of the Parliament within 15 sitting days of that House after the day on which the Minister receives the report.

5.34 The Tax Office advised that a 'PRRT overview position is incorporated each year into the Annual Report which satisfies statutory reporting obligations'.¹⁰² Matters canvassed in the Commissioner of Taxation 2006–07 and 2007–08 Annual Reports¹⁰³ have included the number of registered taxpayers, net collections¹⁰⁴ and reasons for changes in net collections. These two reports have not discussed breaches or evasions of this Act of which the

¹⁰² Tax Office Response to ANAO Audit Criteria, 12 August 2008, p. 8.

¹⁰³ *Commissioner of Taxation Annual Report 2006–07*, p. 115 and *Commissioner of Taxation Annual Report 2007–08*, p. 68.

¹⁰⁴ This provided reporting against Output Group 3.5 in the Tax Office Portfolio Budget Statements.

Commissioner has notice, as required under Section 16(1) of the PRRT Assessment Act.

5.35 To comply with Section 16(1) of the PRRTA Act, details of any breaches or evasions of the PRRT should be included in Commissioner of Taxation Annual Reports, or alternatively noted if there were no known breaches or evasions. Other than this, the ANAO considers that the Tax Office provides adequate external reporting of PRRT performance.

Internal performance monitoring and reporting

5.36 Monitoring and reporting PRRT performance focuses on the progress, particularly timeliness, of compliance risk reviews and audits.¹⁰⁵ This monitoring is undertaken through monthly review meetings conducted with the Director of Petroleum, quarterly case reviews by Segment leaders, half yearly reviews by Large Business and International leaders, aged case reviews and also by updating the Petroleum Industry Compliance Strategy report. Healthcard, a central capture point for potential risks, is also updated and reviewed periodically with a view to identifying priority risks. There is also ongoing monitoring of progress on interpretative assistance and advice activities.

5.37 PRRT administration is a very small component of overall Tax Office administration, with full time equivalent employee numbers of around 12 in an organisation of over 23 000 (around 0.04 per cent). Reflecting this small share of effort, input into core quarterly and monthly governance reporting mechanisms is typically integrated with other petroleum and Energy and Research Segment activities.

5.38 As discussed in paragraphs 5.26 and 5.27, there is an opportunity to extend internal performance measurement by developing, monitoring and reporting against key performance indicators for each recommended strategy in annual PRRT Compliance Strategies documents. By developing a succinct set of key performance indicators on this basis, it would be possible to better gauge whether PRRT strategies and approaches, as set out in the annual PRRT Strategy documents and periodic Petroleum Industry Compliance Strategy publications, are being achieved. This would also provide a clear line of sight

¹⁰⁵ There is also monitoring and reporting of the results of compliance activities, in terms of tax revenue implications.

from PRRT operations to broader LB&I and Compliance Sub-Plan performance, which would help with resourcing and setting other administrative approaches.

5.39 The business intent for PRRT is 'to optimise voluntary compliance under the law in a way that builds community confidence'. While the PRRT Unit constantly reviews plans and strategies to help ensure high levels of voluntary compliance, no such explicit measurement is currently undertaken. Monitoring and reporting against the suite of PRRT Compliance Strategies would provide greater confidence that the business intent for PRRT is being met.

5.40 While quantitative information can provide valuable assurance on what has been achieved, it is also important for senior management to receive positive assurance on the outcome of work that cannot be so readily measured.

Cost efficiency

5.41 The Tax Office does not regularly monitor and report overall costs of administering the PRRT. While data is available to measure salary costs of many general administration tasks, no such costs information exists for PRRT compliance, litigation and interpretative assistance and advice activities, as there are no specific PRRT codes for this work. These costs are included in income tax work generally.

5.42 The ANAO notes that costs to the Tax Office of administering the PRRT are likely to have been relatively inexpensive compared to the magnitude of revenue raised. For example, direct salary costs of the 12 full-time equivalent staff working on PRRT in 2007-08 would have been well under one million dollars, which was around one twentieth of one per cent (0.05 per cent) of PRRT revenue raised.

5.43 There are also a range of PRRT administration costs in addition to direct salary costs, including contributions to corporate overheads, travel, communication, and consultancy/legal fees associated with providing technical advice and litigation.

5.44 Given that PRRT provides a significant revenue stream, has many separate administration tasks, and is facing considerably increased compliance and technical advice/litigation workloads, the ANAO suggests that the Tax Office assesses the cost-effectiveness of monitoring and reporting the cost of administering its main components.

Compliance costs for the petroleum industry

5.45 Compliance costs to industry are also important for PRRT, given the requirements of four payments annually, and the relatively high rate of objections and litigation in recent years. A common view of petroleum industry representatives contacted as part of the audit was that:

- compliance costs for general administration were reasonable;¹⁰⁶
- costs of responding to risk reviews could be quite high, particularly when non-operators were required to provide detailed information such as invoices; and
- the cost of litigation was high (but worth clarifying through the court given the amounts of tax involved), with one company advising it had spent over \$8 million in considering and litigating PRRT issues over the past decade.

5.46 The Tax Office has a biannual survey of business perceptions. In May 2008, 60 per cent of respondents to the survey agreed that the Tax Office tried to make complying with business obligations inexpensive. Fieldwork undertaken for the audit suggests this satisfaction rating would be lower for PRRT taxpayers. On this basis, it is important that the Tax Office further reviews methods to reduce costs, including through including more operators in risk reviews, and risk-based requests for information in risk reviews and audits.



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Auditor-General

Canberra ACT

20 May 2009

¹⁰⁶ Although the timeframes for providing quarterly instalments and annual returns were challenging (as discussed in Chapter 2).

Appendices

Appendix 1: Tax Office Response to the Audit

As you noted, the Petroleum Resource Rent Tax (PRRT) has been administered by the Tax Office since its introduction in 1987. In the 2008 year it generated approximately \$1.7 billion in revenue for the Commonwealth Government, out of \$271 billion collected by the Tax Office. This means it is a comparatively small, but nonetheless important, revenue product.

The Tax Office welcomes the ANAO recommendations on its administration of the PRRT.

It is encouraging to note that the ANAO found that the Tax Office's recent steps to improve its administration have been effective. In particular, we were pleased to note the ANAO found:

- the Tax Office effectively undertakes the core administrative elements of the PRRT, which was supported by industry stakeholders,
- PRRT compliance arrangements and the plans are cohesive and compliance activities are based on sound risk management processes,
- the Tax Office has taken action to increase the level of interpretative assistance and advice to PRRT taxpayers, and
- PRRT governance arrangements are sound.

It was also pleasing to note external stakeholders indicated that skilling levels of Tax Office staff are generally high for PRRT administration.

The Tax Office accepts the four recommendations and provides the following comments.

Recommendation No 1

To better inform compliance programs and facilitate timely resolution of PRRT payment issues, the ANAO recommends that the Tax Office increases the extent to which it makes timely inquiries to resolve apparent PRRT payment anomalies, where this has significant tax liability implications for clients.

Tax Office response: *Agreed.*

Since 2006 the PRRT system has operated under a legislated self assessment regime, whereby the onus is on taxpayers to voluntarily comply with the PRRT laws. While taxpayers have that primary responsibility, the Tax Office will establish risk thresholds in its current processes against which it will initiate timely inquiries to resolve apparent PRRT payment anomalies. Given the

general limitation on resources the Tax Office can devote to managing various risks, such enquiries will be limited to circumstances with significant tax liability implications for clients.

Recommendation No 2

In light of the potential to reduce uncertainty for sophisticated taxpayers in interpreting complex issues with significant revenue implications, the ANAO recommends that the Tax Office provides more extensive written guidance about key aspects of the PRRT, through additional Public Rulings and other interpretative advice.

Tax Office response: *Agreed.*

Providing advice and assistance to taxpayers is a central role of the Tax Office. Last year we issued three public rulings on key aspects of the PRRT laws. In consultation with relevant stakeholders, we are currently identifying high priority PRRT technical issues to form a program of work to provide further guidance to taxpayers. This proposed program will be subject to normal Tax Office process and procedures for assessing priorities that apply to public rulings. We will continue to encourage taxpayers to request private binding rulings at any time if they want certainty as to how the PRRT law applies to their individual circumstances.

Recommendation No 3

To enable timely and cost-effective resolution of technical PRRT issues, the ANAO recommends that the Tax Office strengthens the capacity of the PRRT Centre of Expertise by allocating sufficient time of additional senior lawyers from the Tax Counsel Network to adequately supplement the existing officer.

Tax Office response: *Agreed.*

The Tax Office is currently reviewing its level of Tax Counsel Network PRRT technical support. Additional Tax Counsel Network resources will be allocated on a needs basis to support the timely resolution of PRRT precedential technical issues.

Recommendation No 4

To complete the planning framework for PRRT and support continual improvement in administration, the ANAO recommends that the Tax Office extends the approach taken in 2008–09 PRRT Compliance Strategies to develop, monitor and report against key performance indicators for each recommended strategy.

Tax Office response: *Agreed in part.*

The Tax Office will examine the feasibility of further developing, monitoring and reporting against key performance indicators for its PRRT compliance strategies. Resource and system constraints, as well as the need to ensure consistency in reporting, require that any development is within current systems and reporting frameworks.

Appendix 2: *Petroleum Resource Rent Tax Assessment Act 1987 Amendments*

Date	Amendment	Summary
1991	Exploration cost deductibility was widened from a project to a company wide basis.	This enables undeducted exploration expenditure incurred after 1 July 1990 to be transferred to other projects with a notional taxable profit held by the same entity. In the case of a company in a company group, the expenditure is also transferable to other PRRT-liable projects held in the group.
October 2001	Allowed the Tax Commissioner to apply a gas transfer price formula in the absence of an arms length sale in an integrated gas-to-liquids project.	The reference date for the five year rule applying to expenditure uplifts was changed to refer to the date nominated in a 'Statement of receipt' issued when all information pertinent to the application for a production licence is supplied to the 'Designated Authority'.
October 2003	Removed an inconsistency in relation to tolling fees.	In a tolling situation, the property of one project, such as the platform or processing facilities, may be partially used to produce its own petroleum and partially used to process petroleum sourced from third party projects. The amendments help ensure that all partial usage situations are treated the same way and do not impact on efficient commercial arrangements. The amendments also help ensure that double taxation, black hole expenditures or understatement of net assessable receipts do not affect government or industry.
May 2004	A measure to encourage petroleum exploration in remote offshore areas.	This involves an uplift of 150 per cent on PRRT deductions for exploration expenditure incurred in designated offshore frontier areas. The measure applies to pre-appraisal exploration expenditure in the initial term of the exploration permit granted for a designated area. This measure applies up to 30 June 2008.
2005	Gas Transfer Regulations	The objective of the Gas Transfer Regulations is to provide a framework to determine the price for gas in the case of an integrated gas-to-liquids project. The framework enables a PRRT liability to be calculated in the upstream component of an integrated gas-to-liquids project where there is no arm's length price or comparable uncontrolled price. These regulations allow for a gas transfer price to be determined by the Commissioner of Taxation either by an advanced pricing arrangement agreed with the PRRT taxpayer, an uncontrollable comparable price, or by a Residual Pricing Mechanism. In the circumstances where an advanced pricing arrangement or uncontrollable comparable price does not exist, the Residual Pricing Mechanism prevails. The Gas Transfer Pricing Regulations took effect from 20 December 2005.

Date	Amendment	Summary
May 2005	Changes to reduce compliance costs, improve administration and remove inconsistencies in the PRRT regime.	<p>These changes, which became effective from 1 July 2006, were to:</p> <ul style="list-style-type: none"> • allow the deduction of transferable exploration expenditure when calculating quarterly instalments; • allow the deduction of closing-down costs when moving from a production to an infrastructure license; • allow taxpayers to self assess their PRRT liability; • provide roll-over relief for internal corporate restructuring; • allow the deduction of Fringe Benefits Tax for PRRT purposes; • introduce a transfer notice requirement for vendors disposing of an interest in a petroleum project; and • extend the lodgement period for PRRT annual returns from 42 to 60 days.
8 May 2007	Measures to lower compliance costs and remove inconsistencies.	<p>These measures, which were planned to commence from 1 July 2008, include:</p> <ul style="list-style-type: none"> • a functional currency rule built into the PRRT, similar to that under income tax, which will allow oil and gas producers to elect to work out their PRRT position in a foreign currency; • the introduction of a 'look back' rule for exploration expenditure, ensuring that all exploration expenditure is deductible for PRRT purposes where a production licence is derived from a retention lease on or after 1 July 2008; and • addressing overlap between two petroleum projects, so that where a petroleum project processes petroleum sourced from another petroleum project for a tolling fee, the tolling fee received will be treated as a PRRT receipt, and the expenses incurred will be treated as a PRRT deduction.

Source: ANAO analysis of Tax Office information.

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