PETROFED

Ref. No.: PF/9
November 16, 2016

Dr. T. V. Somanathan
Joint Secretary
Prime Minister's Office
South Block, Raisina Hill
New Delhi 110011

Dear Sir,

Sub: Oil & Gas Industry meeting on fiscal issues

We thank you for giving us an opportunity to present before you the concerns of the Oil & Gas Industry regarding service tax and GST. A copy of the Presentation made is attached for your kind reference (Annexure 1).

As you are aware, the Oil and Gas sector is vital to the growth and sustainability of the Indian economy being a core contributor in every sphere including manufacturing, agriculture, transportation, defence and services. The Policy initiatives and fiscal incentives given by the Govt in the past have met with limited success for a variety of reasons resulting in slowdown in the investments, stagnant oil production and declining gas production.

The industry is going through a rough period. It is submitted that since the launch of NELP, there has been investments of US $ 29 billion in the Exploration & Production (E&P) sector wherein the revenue realised so far is only US $ 14 billion. Investment in the sector has declined in last few years which has resulted in slowdown in exploration and development activities. In order to drive investment in E&P sector, the HELP, DSF and other important policy initiatives were launched earlier this year by the Govt, which have the potential to bring much needed billions of investment in the sector. To underpin these and build confidence of investors in India's Hydrocarbon sector, there is a need for a holistic fiscal framework that is stable and in line with International best practices.

In support of this objective, the following issues require urgent consideration –

1. Service Tax on Government Services - Royalty

Under NELP rounds, post international bidding, based on 'profit sharing' GOI has signed Production Sharing Contracts (PSCs) to share production / profits from the extraction of oil and gas wherein the contractor takes entire exploration risk and brings technical expertise and risk capital. The Government receives from the activity its share of production/profits in case of success through royalty and profit petroleum based on investment multiple formulas incorporated in respective PSCs. The royalty and profit can be shared either in kind or in cash.

The Finance Ministry issued a Circular on April 13, 2016 which stated that periodic payments in relation to any natural resource shall be taxable – such as Spectrum User Charges (telecom) or license fees in respect of spectrum. Post this, some Hydrocarbon companies have received request for information and summons in regard to Royalty from Directorate General of Central Excise Intelligence (DGCEI) field formations.

In the Hydrocarbon sector world over, Royalty in a PSC is merely a nomenclature for share of revenue to the government on which no tax is levied. This is because it is not a rent or license fee (eg paid in private sector for right to use technology, IPRs, patents, formula, brand, telecom licence given by GOI to 3rd party). Royalty in this case is really a part of overall share of revenue to GOI in case of commercial success in exploration leading to production. There is no quid pro quo, GOI is not obliged to render any service in return of Royalty paid by the producer. Royalty in this case is a risk related variable return depending on uncertainties of prospecting, production, levies and price. There are periods when no payments may accrue, which is antithetic to the concept of service consideration. Unlike other sectors including manufacturing/telecom etc, Service Tax on Hydrocarbon sector is a cost as no Cenvat credit is available to upstream companies.

Service Tax in this case is conceptually inappropriate and materially changes the economic basis in the PSC, which provides fiscal stability, adversely impacting hydrocarbon production focus for India and reducing cash flows to the investors risking financial viability. This interpretation and fiscal burden will adversely impact the momentum gained recently by various Policy initiatives taken to increase investment and domestic oil production in the coming years.

It is requested that a clarificatory circular be issued immediately that service tax is not applicable on royalty and other payments in Hydrocarbon sector made to GOI under a PSC.

2. <u>GST – Inclusion of Petroleum and Hydrocarbon Industry</u>

The Constitutional Amendment as enacted includes Petroleum products (MS, HSD, ATF, Crude Oil and Natural Gas) but the date of inclusion within GST framework will be decided by the GST Council. The non-inclusion of Oil and Gas sector at the time of introduction of GST will have huge adverse impact on this sector, India's energy security and will have cascading inflationary impact on various other industries and economy which would impact the competitiveness of "Make in India" initiative of GOI.

Non-inclusion of the sector in GST regime means, various goods and services procured by this industry will be subject to GST, whereas the sale/ supply of Oil, Gas and Petroleum Products, the earlier taxes (i.e. excise duty/ Value Added Tax/ Central Sales Tax, Entry Tax etc.) will continue to apply **without any credits on input GST**. Thus, this industry will be subject to a huge additional indirect tax burden with stranded costs of Rs 25,000 crore – refer to Annexure 2 for details.

Petroleum products directly enter as an input into a large number of economic activities impacting masses (e g, transportation, and electricity generation and fertiliser production). The increase in tax incidence and stranded costs will have a significant inflationary impact on the Indian economy.

In view of the above-mentioned adverse impact for non-inclusion of the Petroleum Products in GST regime, our request is as follows:

Option 1: Petroleum Products are included in the GST

GST is levied on sale/ supply of Petroleum Products. This inclusion will provide free-flow of credit and avoid cascading impact and inflation in the economy. The GST charged on supply of Oil and Gas will be eligible as tax credit to customer, which will ensure that there are only incremental taxes.

Option 2: Oil & Gas is included in the GST regime (at a lower band) with added tier of Excise and Vat

This would involve applying GST together (at the lower rate of say 5%) with an added tier of taxation in the form of a scaled down Excise and VAT. This would help bring petroleum into the GST regime. This will unlock all credits on the procurement side for refineries and E&P operations. Corresponding Excise and VAT rates would need to be reduced under this scenario to keep the products revenue neutral. This is compatible with GST framework.

<u>Submission</u>

In recent times, India's domestic oil and gas production has been on decline while there is a significant increase in consumption leading to increased level of imports. Hence the domestic production of Oil and Gas is critical to India for its energy security and reduction in import dependence. The new and innovative policies combined with fiscally stability through the interventions discussed above will go a long way in unlocking investments of US$ 15-20 billion over next 4-5 years helping to realise the Honourable PM's vision for reduction of Oil and Gas imports by 10% by year 2022.

We request your kind intervention in suitable redressal of the above mentioned concerns of the Oil & Gas Industry and once again thank you for having given us an opportunity of being heard.

Yours sincerely,

Dr. R.K. Malhotra
Director General

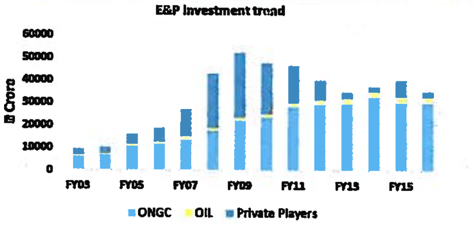
Enclosures: Annexure 1 & 2

Annexure 1

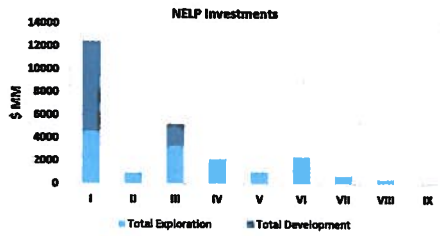
Indian E&P – Investors concern due to changes in fiscal regime

November 2016

India E&P - High Risk with low rewards



Source: Indian Petroleum & Natural Gas Statistics (numerous years), MoPNG; Standing Committee Report No. 19, October 2013; ONGC & OIL Investor presentation



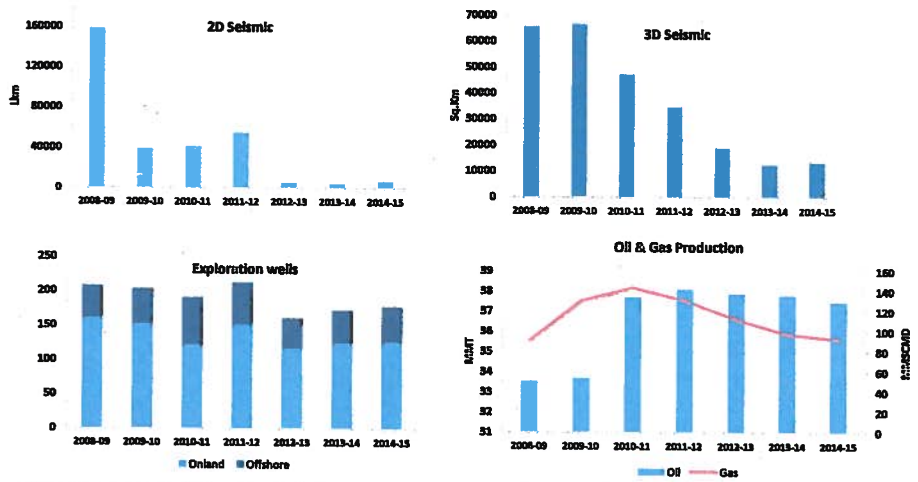
Source: MoPNG Annual Report 2015-16

- 56 Pre-NELP, 254 NELP and 33 CBM blocks awarded in various rounds
- Only 125 PSCs (38 Pre-NELP, 87 NELP) and 17 CBM blocks active
- Out of 145 oil & gas discoveries in NELP blocks, only 6 put in production till date
- In NELP blocks, total expenditure (exploration, development and production cost) of **~$29 Billion**.
- Total revenue generated from NELP **~$14 Billion** and unlikely to generate anything close to investment.

Urgent need to revive E&P sector and realize the vision of 10% import reduction by 2022

2

Exploration activity nose dived - Production on decline



Note: Includes ONGC & Oil nomination blocks, Pvt & JVs

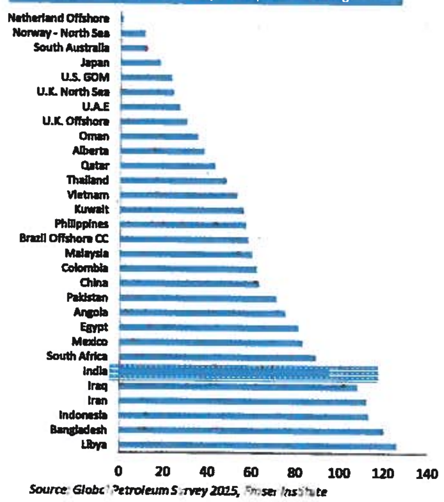
Source: DGH Annual Reports, Standing Committee Report No. 13, May 2016

Fall in domestic exploration & production will continue to further increase dependence on imports

3

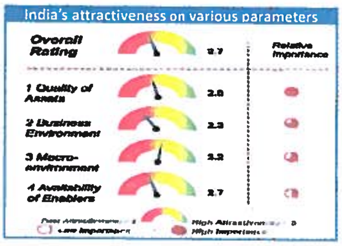
Subdued investor confidence

Global Petroleum Policy Perception Rankings



Source: Global Petroleum Survey 2015, Fraser Institute

India's attractiveness on various parameters



- GoI seeking investments to increase domestic production – implemented series of reforms
- Introducing a new tax would deter prospective investors
- E&P is a high risk business - it is imperative that policies strike right balance between risk & reward and are stable

New taxes further shakes investor confidence

Service tax on Royalty - Imposition of new tax (1/2)

- Production Sharing Contract (PSC) under NELP is based on concept of profit sharing with Royalty as one of the component. Royalty payments on oil & gas should not be taxed as it is:
  - share of GoI in the production of oil & gas and not a license fee as in telecom and coal sector
  - collected by GoI being the sovereign owner of oil & gas resources – not for providing any service
  - a statutory payment under ORD Act 1948 – Non payment attracts penalty & imprisonment u/s 9 of ORD Act
  - without any kind of consideration or no *quid pro quo*
  - paid on well head price in addition to VAT/CST on sell price, the tax on royalty would tantamount to pay service tax & VAT simultaneously

Imposition of service tax on Royalty will increase burden on domestic E&P industry

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Service tax on Royalty - Imposition of new tax (1/2)

- International practice is not to levy Service tax – Service tax is not payable on oil & gas royalties in all major jurisdictions
- Levy of service tax on royalty payments would:
  - erode the competitiveness of oil & gas sector and confidence in investment in the sector.
  - increase costs - not available for set-off (CENVAT Credit)
  - deter future investments inflow – send wrong signals to potential investors
  - compromise the promised fiscal stability

<u>**Request**</u> to issue a clarification that service tax is not applicable on Royalty payment on oil & gas production

India should follow International best practices and not charge Service tax on Royalty

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GST regime – Oil & Gas industry

Implementation of GST in its present form to impact petroleum sector severely for example

- E&P sector is capital & import intensive sector – exempt from Custom duty incl. CVD and SAD for inputs
- For E&P sector, input goods & services required to conduct petroleum operations would be under GST – Crude oil & Natural Gas out of GST. Hence no credit would be available
- For downstream sector, over 70% of input GST credit cannot not be utilized as HSD, MS & ATF are out of GST
- For the sector, this would lead to further increase in cascade of taxes which will increase to input cost
- The increased input cost will result in higher costs for key industries – transportation, fertilizer, exports etc. - leading to inflation.

Include Petroleum Sector under GST

GST Proposal

Option 1

- Include Petroleum Sector fully under GST

Option 2

- Continue with existing taxes (VAT/excise) and include excluded goods (e.g. Crude & Natural Gas, MS, HSD and ATF) within GST at a lower band (say 5%) to enable flow through of input credits

Summing up

- Oil & Gas exploration is capital intensive and very high risk business – success rate for commercial discovery <10%
- Indian E&P sector already in downturn – investments declining
- Urgent policy intervention required to reverse the declining investment trend
- NELP & PSC provides for fiscal stability
- Levy of service tax on royalty payments would:
    - compromise the promised fiscal stability
    - erode the competitiveness of oil & gas sector
    - increase costs - not available for set-off (CENVAT Credit)
    - deter future investments inflow
- Include Petroleum Sector under GST

Significant planned investments are looking for progressive fiscal policy initiatives to realize Hon'ble PM's vision

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Thank You

Impact of policy changes – an Illustration

- A Company awarded 3 Exploration Blocks under NELP regime
- Block 1 relinquished after Phase-I: Sunk cost US$ 167MM
- Block 2 relinquished after Phase-II: Sunk cost US$ 239MM
- A Commercial Gas Discovery made in Block 3 during Phase-I
  - The Discovery is appraised and developed
  - Development Period of 3 Years
  - Production Period of 13 Years
  - Abandonment activities during last year of production
  - Expenditure (US$ MM): Exploration (431); Appraisal (180); Development (2,250); Abandonment (250); Production (125)
- Discount Factor: 10%

Investment Multiple	<1.5	1.5-2.0	2.0-2.5	2.5-3.0	>3.0
Contractor Share %	90	80	70	60	50
Govt. Share %	10	20	30	40	50

THREE Scenarios considered for evaluation

- Scenario I: Fiscal Regime as envisaged under NELP
- Scenario II: Current Scenario with Market Freedom
- Scenario III: Likely scenario post GST including taxes on Royalty and GOI PP

	Scenario I	Scenario II	Scenario III
Tax on Materials	0%	0%	18%
Tax on Services	0%	15%	18%
Tax on Royalty	0%	0% @	18%
Tax on GOI PP	0%	0% @	18%
GoI Royalty	On WHV	On Sale Price	On Sale Price

Note: Gas Price Ceiling of $ 6.61 / MMBtu is considered

@ As per MOF these are also subject to Service Tax @15% though industry feels otherwise and has represented the matter

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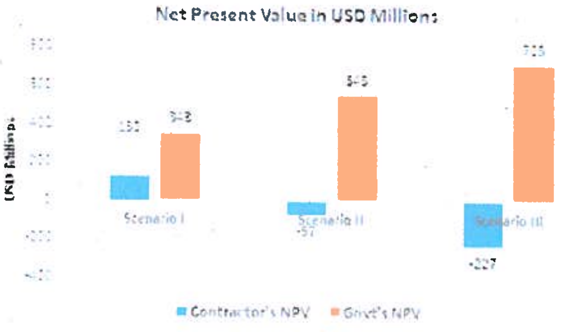
Impact on economic benefits



- Scenario I *(Fiscal Benefits assured under NELP Policy)*
- Scenario II *(Service Tax @ 15% on services)* – No incentive to contractor
- Scenario III *(Post GST including tax on Royalty & PP)* – Not making any economic sense to invest in Indian E&P sector

Fiscal regime to encourage investment towards achieving energy security

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Annex 2

Stranding of Taxes

Rs/Crore

Particulars	Tax Stranding		
	Current	Incremental	Post GST
CST On Crude	611	0	611
VAT on Crude (without ITC)	1653	0	1653
CST on MS,HSD, ATF	1600	0	1600
IGST on Imported goods used in Upstream	0	1721	1721
Tax on Indigenous goods used in Upstream	541	946	1487
Tax on services (both imported & indigenous) used in Upstream	4559	3042	7601
Duties & Tax on goods and services used in refinery for manfufacure of MS,HSD & ATF	0	5372	5372
Duties & Tax on goods and services used in distrbution & marketing of MS,HSD & ATF	0	2183	2183
Loss of excise duty exemption to NE Refineries	0	2039	2039
TOTAL	8964	15303	24267