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Dr. Hasmukh Adhia
Secretary (Revenue)
Ministry of Finance
Department of Revenue
North Block, New Delhi

Sub: Oil & Gas Industry fiscal issues

At the outset, let me take this opportunity to introduce ourselves as Federation of Indian Petroleum Industry, the erstwhile PetroFed which stands amalgamated with Petrotech society and the amalgamated entity has acquired the new name. While the overall objectives of the new entity essentially remain the same, we have now become the largest body representing the oil and gas companies in India.

We wish to take forward some of the critical issues being faced by the oil and gas companies which have already been flagged by us with the Govt for quite some time and request your kind intervention and support for their speedy resolution.

As submitted by us earlier, the industry is going through a rough period with investments in the E&P sector virtually stagnating particularly in the private sector. In order to drive investment in E&P sector the HELP, DSF and other important policy initiatives were launched earlier this year, which have potential to bring the much needed billions of investment in the sector. To underpin these and build confidence of investors in the Indian Hydrocarbon sector there is a need for a holistic fiscal framework that is stable and in line with best international practices.

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

1. GST – inclusion of all Petroleum Products

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 and could possibly have cascading inflationary impact on various other industries and economy which would impact the competitiveness of "Make in India" initiative of GOI.

Federation of Indian Petroleum Industry
PHD House, 2nd Floor, 4/2, Siri Institutional Area, August Kranti Marg, New Delhi-110016,Tel : +91-11-26537483, 26537062, 26537069, 26535284, 26535216, 65664067
Fax : +91-11-2696 4840, E-mail : fipi@fipi.org.in, Website : www.fipi.org.in

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 subjected to a huge additional indirect tax burden with stranded costs of about Rs 25,000 crore. This is going to adversely affect each and every company operating in the oil & gas sector in India.

We had earlier suggested various options to the Govt like "Zero rating" or including them in GST at the lowest band rate of say 5 % with and added tier of Excised duty and VAT at a scaled down rates with the primary intention of finding out some mechanism by which the stranding of taxes in the hand of the industry could be avoided. We shall be grateful if the Govt could consider any of these suggestions so that the industry could be saved from this huge extra financial burden.

We would like to highlight that what we are merely asking for is that the petroleum industry should not be in 'worse off' position with the introduction of GST as compared with the existing regime, which you would kindly appreciate is logical and a fair demand.

We shall be extremely grateful if we are provided an opportunity to present the case on behalf of the industry to the GST Council in its next meeting scheduled in the first week of March 2017 and request for your kind support in this regard.

2. <u>Service Tax on Government Services - Royalty, Cash calls and Cost Petroleum etc</u>

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 through royalty and profit petroleum based on investment multiple formula incorporated in respective PSCs.

However, certain actions by the Tax authorities based on the interpretation of applicability of service tax on royalty, profit share, cost petroleum and cash call have created serious challenges for the Indian Oil and Gas sector. The field formations have issued notices for levy of service tax to various oil and Gas companies which is cause of serious concern since it is dampening the momentum gained from the recent policy reforms announced by the Govt and is impairing the investment attractiveness.

In recent times, India's domestic oil and gas production has been on the decline while there is a significant increase in consumption leading to increased level of imports. Globally, India is the 3rd largest consumer of Oil and Gas with a very high dependence on imports. Hence the domestic production of Oil and Gas is critical to India for energy security and reduction in import dependence. The new and innovative policies combined with fiscal 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 therefore request that the general concerns of the oil & gas sector in India be suitably addressed at the earliest.

We are enclosing a self-contained note covering both the above issues and request as under:

1) We may please be allowed to present our case on behalf of the industry before the GST Council in its next meeting scheduled in the first week of March 2017.

2) We also wish to seek an appointment with you to present the case in person and shall be grateful if you could give some time to us at the earliest.

Thanking you,

Yours faithfully,

Dr. R.K. Malhotra
Director General

Encl. as above

Note on Fiscal issues faced by Oil & Gas Sector companies in India

Inclusion of Petroleum Products under GST

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 subjected to a huge additional indirect tax burden with stranded costs of about Rs 25,000 crore. (Refer Annexure 1 for details) This is going to adversely affect each and every company operating in the oil & gas sector in India, which we certainly believe is not the intention of Government of India.

We shall be grateful if the Govt could consider any of following suggestions so that the industry could be saved from this huge extra financial burden

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.

However, if the consensus is not reached on this point during GST Council Meeting, we would request for inclusion of at least Natural Gas under the ambit of GST from the date of introduction of GST itself. Natural Gas is predominantly used by industrial units and is an environment-friendly fuel, its inclusion should not be dependent on the treatment being proposed for other petroleum products. This view was also taken in the report by the Task Force of 13th Finance Commission on the first discussion paper for GST at Para 2.33 which is reproduced below:

> "Natural gas like petroleum products is derived from the same source. However, unlike petroleum products, natural gas does not generate negative externalities. Therefore the tax regime for natural gas should be distinctly different from the regime applicable to petroleum products. Accordingly, natural gas should be subjected to only GST (both central and state) with all benefits of input credit as in case of other normal goods. We recommend accordingly."

Option 2: Oil & Gas is included in the GST regime with added tier of Excise and Vat

This would involve applying GST together (at the lowest rate) 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.

Alternatively, the Govt could consider bringing these products under the fold of GST at Zero rate.

Deemed export Benefit

Under GST implementation one of the core principles is that no particular industry sector should unduly be worse off in comparison to the existing regime. In this context it should be noted that all major infrastructure contracts and upstream projects enjoy a "Deemed Export Benefit" on all projects which have followed the International Competitive Bidding process under Chapter 7 of the Foreign Trade Policy. This provides exemption from excise duty and CVD for all goods used for the Project. In particular, the investment in Oil and Gas upstream industry is dependent on this benefit due to very high project cost and unavailability of the set off of input taxes.

It is therefore necessary to provide similar Deemed Export Benefit under the GST regime for Oil and Gas industry to avoid significant increase in capital cost for this industry. This can be done by including Supplies to upstream projects under the definition of deemed export in the GST laws which will enable the upstream companies to claim refund of the input taxes under the refund provisions.

Service Tax on Government Services - Royalty, Cash calls and Cost Petroleum etc

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 through royalty and profit petroleum based on investment multiple formula incorporated in respective PSCs.

However, certain actions by the Tax authorities based on the interpretation of applicability of service tax on royalty, profit share, cost petroleum and cash cost have created serious challenges for the Indian Oil and Gas sector. The field formations have issued notices for levy of service tax to various companies operating in oil and gas sector in India which is cause of serious concern since it is dampening the momentum gained from the recent policy reforms announced by the Govt and is impairing the investment attractiveness.

Service Tax on Royalty and Profit share paid to the Government

In the Hydrocarbon sector world over, Royalty in a PSC is merely a nomenclature for share of reward 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, formula, brand, telecom licence given by GOI to 3rd party). Royalty in this case is really a part of overall reward to GOI in case of commercial success in exploration leading to production. It is pertinent to note that PSC is like a public private partnership (PPP) and hence by implication not a service contract. 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. Government and the oil & gas companies are actually joint / co-ventures under the contract and hence Government share in revenues ("Royalty" and "Profit share") cannot be treated as payment of consideration by one member of the venture to the other for services. 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 damaging hydrocarbon production important for India and causing financial loss to the investors reducing cash flows. This interpretation will damage the momentum from the global best practices and various Policy initiatives taken to increase investment in the sector.

Service Tax on Cash Calls

The oil & gas companies as per the Production Sharing Contract (PSC) typically work as an unincorporated joint venture where one of the constituents is the "Operator". The Operator incurs all costs based on a pre-agreed work program and budget between the parties and the Government. The Operator recovers the cost incurred from other parties periodically by raising a "Cash Call". Cash calls are purely funding arrangements / reimbursements towards execution of work program under the contract. Operator makes no profit or loss while collecting Cash Calls from other parties. However, disregarding the nature of transaction, Director General of Customs and Excise Intelligence (DGCEI) have issued summons to all major oil & gas companies calling for extensive data / information since 2011 and have also issued Show Cause Notices to some companies. This will result unnecessary litigation for the entire industry.

__Service Tax on Cost recovery (cost petroleum)__

The Government assigns exploration and production rights to the Contractor for exploration, development and production of hydrocarbons. As per the PSC, parties incur expenditure on oil & gas exploration, development and production activities and these expenditures are recovered from the revenues ("Cost recovery"). The balance of revenue after recovery of expenditure is shared between the Government and parties based on a pre-agreed ratio as Profit share as per the contract. Further, cost of services availed by the Contractor for production of hydrocarbon has already suffered/liable to applicable service tax. Therefore any further service tax on the Cost recovery will tantamount to double taxation.

Some of the oil & gas companies have been issued a show cause notices proposing to levy Service Tax on this Cost recovery. This notice has been issued on the basis that "Cost recovery" is a consideration paid by the Government against the services rendered by parties under the contract with the Government. These notices have been issued without appreciating that Cost recovery is a mechanism to share revenue and there are no services involved.

As mentioned above, none of the above activities are in the nature of service and any additional taxation will have serious adverse impact on oil & gas companies. Service Tax on upstream is a cost as no Cenvat credit is available on the same. These ambiguity of levy of Service Tax on Royalty, Profit share, Cash Calls and Cost Petroleum will dampen the momentum from the global best practices and policy initiatives rolled out, impairing investment attractiveness by existing and future participants.

It may be highlighted that globally in none of the countries above activities the companies are subjected to indirect taxes. These ambiguities of levy of service tax will dampen the momentum from the recent policy reforms announced by the Government.

Stranding of Taxes **Annex 1**

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