

Clarity in Fiscal Policy on Mineral Oil and Natural Gas

The petroleum sector is a strategic industry for the economy and has traditionally been closely regulated, with the exploration and production activities being primarily concentrated in public sector companies.

In order to attract private investment in the oil and gas sector, in 1999, the Government of India ("GoI") formulated the New Exploration Licensing Policy ("NELP" or the "Policy"). The Policy sought a paradigm shift from the pre-NELP regime under which ONGC and OIL were granted a "Petroleum Exploration Lease" on a nomination basis. The Policy framework seeks to provide a level playing field to the domestic public sector companies, private companies, and foreign companies, by offering similar regulatory and contractual terms for exploration and production of oil and gas. Also included is a seven year tax holiday from the date of commencement of commercial production.

A policy of this stature requires a legal and sovereign commitment from the Government to provide a stable fiscal regime throughout the contract period. While there have been several instances in the past where fiscal stability and certainty has been fiddled with, this article focuses on one key issue emanating from the recent spate of interpretational changes in the area of tax holiday for natural gas.

In 2008, one of the announcements made in the Union Budget generated immense debate relating to the tax holiday for the upstream and refining sectors. The Finance Minister proposed to amend the existing provision of section 80IB (9) of the Income tax Act, 1961 ("IT Act") to insert a sunset clause of a tax holiday for refining of mineral oil. As per the amendment, the tax holiday would not be available for an undertaking which begins the refining of mineral oil at any time on or after April 1, 2009. In the finalized law, the tax holiday was extended till March 31, 2012, for notified public sector refineries; however, the maximum collateral damage that emerged affected upstream oil and gas producers.

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Tax holiday for 'mineral oil'

Section 80IB (9) of the IT Act, inter alia, provides for a seven year tax holiday for an undertaking which begins commercial production, or refining, of mineral oil. This provision was introduced as a statute by the Finance Bill 1999. Though the Memorandum to the Finance Bill, 1999 did not elaborate the rationale for introduction of the tax holiday, the intent of introducing a seven year tax holiday for mineral oil production could well be ascribed to the governments consistent endeavors to encourage oil and gas production and to achieve self-reliance in the production of primary fossil fuels, given the high import dependency of India to meet its energy needs.

The relevant tax provisions, however, do not define the term mineral oil. The Memorandum explaining the tax provisions in the Finance Bill, 2008, in the context of the introduction of the sunset clause for refining of mineral oil under section 80IB states that: "For the purpose of this section, the term mineral oil does not include petroleum and natural gas, unlike in other sections of the Act."

Since the term mineral oil is used both in the context of refining and commercial production of mineral oil, the statement in the Memorandum has repercussions on the interpretation of the tax holiday for the commercial production of mineral oil. Before one delves into the commonly accepted interpretation of mineral oil, in the context of section 80IB (9) prior to the introduction of the Finance Bill, 2008, it is pertinent to examine the possible financial impact of the denial of the tax holiday. Impact of the loss of a tax holiday – some number crunching
A simplistic (non-weighted) net cash flow analysis for a deepwater oil and gas field (with exploration costs of about USD 150 million and development cost of about USD 650 million) would suggest that, vis-à-vis a tax holiday scenario, the absence of a tax holiday could result in reduction in the project NPV (assuming a cost of capital of 10 percent) by USD 200 million over a production phase of 18 years.

A similar analysis for a relatively smaller field (with exploration costs of about USD 20 million and development costs of about USD 70 million) explains that, vis-à-vis a tax holiday scenario, the absence of a tax holiday could result in reduction in project NPV (assuming a cost of capital of 10 percent) by approximately USD 35 million over the same number of years.

Such a significant impact on returns, in a high-risk upstream project, could result in the project becoming unviable, inducing reluctance on the part of the investors to participate in future rounds of NELP.

In terms of the Internal Rate of Return, both in case of a deepwater oil and gas field and a small field, a non-tax holiday scenario could result in reduction in the projects Internal Rate of Return by 4-5 percent vis-à-vis tax holiday scenario. Clearly, the non-availability of the tax holiday will have serious repercussions on the cumulative return on investments.

Non-availability of the tax holiday may have serious repercussions on the cumulative return on investments.

Mineral oil – Definition

Section 80IB of IT Act does not define the term mineral oil. To interpret its meaning, reference can be made to the definition of mineral oils under other substantive provisions of the IT Act; industry laws for petroleum operations in India; common parlance and dictionary definitions.

Definitions under the IT Act

Section 42, section 44BB and section 293A of the IT Act, inter alia, define mineral oil to specifically include petroleum and natural gas.

The meaning of mineral oil has also been discussed in Circular 57, dated March 23, 1971, issued by the Central Board of Direct Taxes (CBDT). The CBDT circular defines mineral oil to include crude oil (crude petroleum) and the liquid products derived from crude petroleum which are in the nature of mixtures of hydrocarbons. The aforesaid definition has been acknowledged by the CBDT in the following context:

- for calculation of super tax rebates under the Finance Act, 1964 and the Finance Act, 1965;
- for calculating development rebate reserve under section 33 of the IT Act; and
- also, applying the same reasoning, the CBDT regarded the business of refining of crude oil as a priority industry for the purpose of section 80I and section 80M of the IT Act.

The above meaning / interpretation of mineral oil was also referred to and relied upon by the Bombay High Court in the case of CIT vs Caltex (India) Ltd (177 ITR 239) in examining whether the assessee was eligible to claim special deduction under section 80E / 80I of the IT Act. Also, in *Burmah Shell Refineries Ltd vs G B Chand*, ITO (61 ITR 493), the Bombay High Court held that the expression mineral oil, as appearing in item (3) of Fifth Schedule of the IT Act, has to be understood, in a limited sense, as referring to mineral oil, crude oil, and petroleum; and not its finished products. Though arguably, the setting and the context in which the aforesaid definition / meaning of mineral oil has been accepted by the Court / CBDT, it is different from that under section 80IB (9) of the IT Act.

However, reliance can be placed on the above definition (which has also been accepted by courts in the past) for interpreting the term mineral oil in the context of section 80IB (9) of the IT Act. Definitions under Petroleum rules / laws Oilfields (Regulation and Development) Act, 1948 (ORDA) which governs the petroleum operations and provides rules for regulation of oilfields and development of mineral oil resources, defines mineral oils to include petroleum and natural gas. The Petroleum Tax Guide, 1999, also provides that Production Sharing Contract (PSC) participants who begin commercial production of petroleum in any part of India, on or after April 1, 1997, shall be entitled to claim deduction under section 80IB of the IT Act, of 100 percent of their profits and gains derived from such business. The term petroleum has been defined in the Tax Guide to mean crude oil and / or natural gas existing in their natural condition but excludes helium which occurs in association with petroleum or shale.

Guidance under Model PSC for CBM1 operations Model PSCs are drafted by the Ministry of Petroleum and Natural Gas, Government of India.

1. Coal Bed Methane
2. Model PSC which forms basis of signing of Production Sharing Contract with successful bidder is prepared by

Expressions in the Model PSC would have persuasive value in interpreting the meaning of mineral oil.

The Model PSC³ for CBM operations defines CBM as natural gas and inter alia, mentions that the contractor shall be eligible for benefits under section 80-IB, as applicable from time to time.. Though section 80IB does not explicitly define mineral oil to include natural gas, a specific reference to tax holiday provisions of the IT Act under the Model PSC in the context of production of natural gas, further strengthens the contention that the seven year income tax holiday under section 80IB would be available to the production of natural gas as well. Common parlance / dictionary meaning Industry focussed dictionaries define Mineral oil as a derivative of petroleum. For instance, the Petroleum Dictionary defines mineral oil as a wide range of products derived from petroleum and within the viscosity range of products spoken of as oils.. The Dictionary of Energy⁴ defines mineral oil as a colourless liquid petroleum

derivative with little discernible odor or taste, widely used as a lubricant and for various other purposes.

Section 80IB of the IT Act does not define the term mineral oil. To interpret its meaning, reference can be made to definitions of mineral oils under other substantive provisions of the IT Act; Industry laws for petroleum operations in India; common parlance; and dictionary definitions.

The Ministry of Petroleum & Natural Gas in consultation with stakeholders and industry bodies so as to take care of their concerns, which is duly approved by Empowered Committee of Secretaries (ECS). The Model PSC as approved by ECS is finally vetted by Department of Legal Affairs before launch of new round of New Exploration Licensing Policy (“NELP”). 3 Production Sharing Contract 4 Dictionary of Energy, Cutler J Cleveland and Christopher Morris, Elsevier, First 2006

Clearly, as per the dictionary definitions of mineral oil and petroleum, mineral oil is a derivative of petroleum. The literal interpretation of the above definitions would suggest that even crude oil obtained cannot be classified as mineral oil since crude oil, in its natural form, is not a derivative of petroleum.

The above interpretation of mineral oil, if adopted for analysis, would frustrate the tax provisions under section 80IB (9) of the IT Act as the narrower definition would render the tax holiday provisions redundant [by rendering crude oil, petroleum and natural gas out of the ambit of section 80IB (9)].

Which interpretation to use?

Relying on the dictionary meaning of mineral oil as an interpretative aid may render the tax holiday, for mineral oil concerns, redundant as crude oil as well as petroleum and natural gas would be outside the tax holiday ambit. The other interpretative aids (i.e., other sections of the IT Act and allied laws etc.), may, therefore, provide a logical underlying interpretation of the term mineral oil.

A pragmatic perusal of the alternate interpretive aids suggests that petroleum, including crude oil and natural gas, should qualify as mineral oil under section 80IB(9).

Legal status of the Memorandum

The Memorandum explaining the provisions of the Finance Bill is neither an enactment nor a circular / notification. The purpose of the Memorandum is only to amplify the proposed amendments and explain the underlying intent thereof. While the contents of the Memorandum have a persuasive value, these cannot be equated with fiscal legislation.

The legal status / enforceability of the Memorandum was also echoed by the Finance Minister in his speech in Parliament on April 29, 2008. The relevant excerpts from the Finance Ministers speech are as follows:

“...Nevertheless, I wish to clarify certain doubts that may have arisen because of the Notes on Clauses attached to the Finance Bill. The statement in the Notes on Clauses is a mere re-statement of the Income Tax Departments known position before the tribunals / courts which are adjudicating the matter. Besides, it is a well settled proposition of law that Notes on Clauses have no legal effect and are not binding on the courts. I may assure potential bidders that the benefit of Section 80IB (9), as finally interpreted by the courts, will be applicable to

all exploration and production contracts, whether obtained through nomination or bidding...”

Clearly, the statement in the Memorandum is not a law or enforceable amendment in the prevailing scheme of the law. The Finance Ministers aforesaid statement would be significant; in so much as it would reaffirm that the statement in the Memorandum is the position of the Revenue and not the Legislature.

A pragmatic perusal of the alternate interpretive aids suggests that natural gas should qualify as mineral oil under section 80IB (9). Tax holiday hangs in the balance

The statement in the Memorandum has set the cat among the pigeon.

The Finance Ministers statement that it would be the courts prerogative to decide whether mineral oil includes petroleum and natural gas, has not allayed the fears surrounding the claim for tax holiday for mineral oil production. If anything, the announcement is likely to bolster the contention of Revenue authorities which may challenge any claim for tax holiday on natural gas.

A conclusive interpretation may be achieved only at the High Court / Supreme Court level, the outcome of which cannot be predicted since the outcome is dependent on which interpretation would find favour with the Courts.

Way forward

Litigation is a definite fallout of the statement in the Memorandum and the subsequent statement by the Finance Minister. The initial judicial decisions, not yet in the public domain, are understood to be in favour of natural gas being within the definition of mineral oil. The litigation which is now at the doorstep of the tax tribunals will wind its way to the Courts, and finally the Supreme Court. In the meantime, it is possible that foreign investors could seek a binding ruling from the Authority for Advance Rulings.

It is quite possible that the tax holiday would be a reality for production of natural gas, with a positive outcome from the judiciary, unless the Government disturbs such finding with a change in law. That would be regressive as it would damage the credibility of the NELP, and hurt the much needed flow of exploration capital to India. Other developments

Amendment by Finance (No 2) Act, 2009

The Finance (No 2) Act, 2009, inserted new sub-clauses (iv) and (v) under section 80IB (9) of the Act, which specifically provides for a tax holiday in relation to commercial production of natural gas in blocks licensed under NELP VIII / CBM IV which begin commercial production on or after April 1, 2009.

While these separate sub-clauses provide for clarity with regard to the tax holiday for production of natural gas under NELP VIII / CBM IV, the issue of whether mineral oil includes natural gas remains unresolved (except to the limited extent of the ruling of the Ahmedabad Tribunal). Accordingly, the eventual outcome on the eligibility of natural gas production from blocks licensed before NELP VIII / CBM IV is likely to be ultimately decided by the higher judiciary.

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