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Review of Employee Share Schemes
The Board of Taxation
c/- The Treasury
Langton Crescent
PARKES ACT 2600

Email: taxboard@treasury.gov.au

Review of Elements of the Taxation of Employee Share Scheme Arrangements

The Australian Petroleum Production & Exploration Association Ltd (APPEA) is the peak national body representing the collective interests of companies engaged in petroleum exploration, development and production in Australia. The Association's membership comprises companies that account for an estimated 98 per cent of Australia's petroleum production and the vast majority of exploration.

APPEA is pleased to provide the comments below in relation to the review that is being undertaken by the Board of Taxation into selected aspects of the taxation of employee share scheme arrangements.

The Role and Challenges Confronting Small Independent Exploration Companies

There is a diverse range of entities active in the oil and gas industry in Australia, with small to medium-sized companies playing a critical role. Small companies make up the largest group by number, with many only employing a handful of staff. Some generate relatively small amounts of income, while many are reliant on equity markets to fund their on-going exploration activities.

It is well recognised that the role played by junior petroleum exploration companies is crucial to the overall health and vitality of the sector. While exploration by juniors represents a relatively modest proportion of the total pool of funds spent on exploration, it is nonetheless important to the total effort. This is particularly the case for onshore exploration, where the last twelve months has seen a dramatic fall in the level of activity undertaken.

In Australia, small independent explorers have shown an ability to identify, explore and develop petroleum resources at a scale that does not necessarily attract larger entities. This has led to both new discoveries and the incremental production from declining fields. The diversity in size and activity among participants in the Australian petroleum industry has been a major contributor to its success. From small explorers to the large international companies, all must continue to be active if the industry's economic potential is to be realised.

HEAD OFFICE

Level 10
60 Marcus Clarke St
Canberra ACT 2601

GPO Box 2201
Canberra ACT 2601

T +61 2 6247 0960
F +61 2 6247 0548
E appea@appea.com.au
ABN 44 000 292 713

BRISBANE OFFICE

Level 9
10 Market St
Brisbane QLD 4000

GPO Box 1151
Brisbane WA 4001

T +61 7 3229 6999
F +61 7 3220 2811
E brisbane@appea.com.au

PERTH OFFICE

Level 1
190 St Georges Tce
Perth WA 6000

PO Box 7039
Cloisters Square
WA 6000

T +61 8 9321 9775
F +61 8 9321 9778
E perth@appea.com.au



From a fiscal perspective, it is essential that taxation settings provide a balance across the company and investment spectrum to ensure a framework exists to reflect the different commercial factors and risks that confront companies. The Federal Government's recognition of the case for the possible introduction of a flow through share system represents a clear example of governments recognising the challenges that confront small independent oil and gas companies in Australia. APPEA sees the taxation treatment of employee shares as being another important fiscal instrument that assists smaller companies in attracting, retaining and remunerating staff.

Employee Share Scheme Reforms

APPEA notes the Federal Government's decision to modify the taxation treatment of shares and rights acquired under employee share schemes announced within the 2009-10 Federal Budget. We also recognise the modifications that have been made following subsequent dialogue with the business community and stakeholder groups. While we remain concerned with some aspects of the proposed reforms (including the possible impact of retrospective changes to the tax treatment of shares that have already been allocated to staff), APPEA welcomes the Assistant Treasurer's decision to allow the Board of Taxation to examine a number of critical issues, including whether shares and rights issued under an employee share scheme by speculative companies should have separate tax deferral arrangements.

Activities undertaken in connection with petroleum exploration are speculative by their very nature. For companies with significant income streams, many of the inherent risks can be spread across a portfolio of exploration and production activities, however this ability to spread risk generally does not exist for companies with little production or for those that are purely exploration focused.

The lack of income also greatly constrains the ability of many small independent companies to directly remunerate staff through wages and salaries – monies spent on this category of cost directly limits funds available to undertake physical exploration (whether that be the drilling of wells or acquiring seismic data). In practice, the majority of small exploration companies are heavily reliant on utilising flexible remuneration packages to attract and retain quality staff. In effect, the granting of shares and/or options with performance hurdles and/or variable vesting rights allows these companies to compete for human capital. The growing pressure associated with the shortage of skilled labour is making it even more difficult for these companies to compete for staff.

In addition to the above, the global financial crisis has significantly constrained the ability of many such companies to access capital and funds from equity markets, while the rise in exploration costs over the last three to five year has placed extreme pressures on the budgets of companies with funds available to explore. Many have needed to defer exploration commitments and programs.

APPEA considers that a compelling case exists for allowing the employees of such companies to be subject to modified taxation provisions for shares they have acquired as part of the remuneration package. This would directly assist companies in addressing the competitive and financial disadvantages that they face in employing staff, for the reasons outlined above. Criteria that could be used to define eligible entities could include an annual turnover or revenue threshold, market capitalisation, staff numbers or a combination of these factors.



It is recognised that any carve-out or special framework for shares or right issued by eligible entities would need to be appropriately structured to ensure integrity and transparency in reporting and the payment of any ultimate taxation liabilities by employees.

Aligning employer/employee interests and encouraging the direct participation of staff in the broader corporate objectives of small independent exploration companies is an important factor that will influence the future contribution that such entities can play in securing Australia's energy future. We would be pleased to further discuss the issues raised above. Contact in APPEA is Noel Mullen (nmullen@appea.com.au).

Yours sincerely

A handwritten signature in black ink, appearing to read "Belinda".

Belinda Robinson
CHIEF EXECUTIVE