Marathon Petroleum Company (Norway)

FINANSDEPARTEMENTET
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Finansdepartementet
Skattelovavdelingen
Postboks 8008 Dep
0604 OSLO
Attn: Stig Sollund

10 August 2006

Consultation – tax treatment of financial items

We refer to your letter of 2 June 2006 concerning the Ministry of Finance's proposed changes to the tax treatment of financial items and we thank you for inviting us to comment on the changes being considered.

Introduction – Marathon in Norway

Marathon has been involved in Norway since 1980 and was approved for its first operatorship on the Norwegian Continental Shelf in 2002. In the following years, the company discovered and submitted a development plan for the Alvheim field and has invested in the Vilje field; both fields are expected to be on stream as early as next year. Marathon is now planning to expand in the Alvheim area by making future investment in Volund. Total investment in the Alvheim area will exceed $1 billion. In addition, the company has a number of interests in exploration licenses on the Norwegian Continental Shelf and hopes that future exploration successes will help consolidate Norway's position as a strategic and growing core area for Marathon.

Commentary on the changes

The themes with which the Consultation document opens, namely the high rate of tax offshore and the significance of interest deductions to taxpayers, are key features in Marathon's perspective. These two themes are of course related as interest deductions assume their significance partly due to the high tax rate. The high capital cost of projects and the relatively long payback periods are other aspects of offshore oil investment which explain the importance of interest deductions to a project's economics.

A corollary of the importance of interest deductions is the high impact of fiscal regime change, particularly where the tax rate is high. With a 78% rate, the effect of recategorising $100 of expenses as disallowable is the same as sacrificing net operating revenues of $355 (both result in an after-tax loss of $78). Hitherto, the Norwegian offshore tax regime has been characterised by a high degree of stability, which has compensated in part for the high tax rate. Stability is especially important for Marathon at its current stage in the investment cycle. We have committed significant funds to developments in the Alvheim area, using the existing fiscal regime to support our original investment decision, and our investment stake in this area is now near its maximum. We would of course agree that fiscal change is

Visiting Address
Bjergstedveien 1
4007 Stavanger, Norway
Tel: (+47) 51 50 63 00
Fax: (+47) 51 50 63 01

Postal Address
P.O. Box 480 Sentrum
4002 Stavanger, Norway

NO 935 977 978

sometimes justifiable. However, in the present instance, the proposed changes are particularly undesirable in two respects they are retroactive and they are discriminatory.

The changes are retroactive in that they impact on existing investments, just as much as they impact on future investments. Although investors in new projects are able to factor in the new rules into their investment decisions, investors in existing projects are liable to see large deteriorations in the economics of investments which are either sunk or committed. In other similar situations, well-designed transitional rules might be expected to soften or remove the impact of change on existing projects. In these specific circumstances, however, it is not easy to imagine how a viable set of effective transitional rules could be implemented. The problem of retroactivity is therefore one which will not be easy to address, and one which the consultation document in fact does not propose to address at all. This is unsatisfactory.

The changes are also discriminatory. In broad terms, it would seem that the smaller players and new entrants investing exclusively in the offshore would suffer the most, while larger companies with mature portfolios and/or significant onshore investments would benefit (or at least suffer the smallest disadvantages). This is because it will tend to be the smaller players who, because of their stage in the investment cycle, are likely to have the least mitigation against the harshest effects of the new regime. Established players with mature portfolios, on the other hand, may well have temporary operating surpluses which can earn interest income, for which there will be a relaxation of the tax treatment under the proposals in their current form. Those companies with onshore income will in addition benefit from the onshore deduction for excess offshore interest expense. Marathon sees no basis for discriminating against players with less mature portfolios or exclusively offshore companies in this way. Indeed, it is surprising that the Ministry is contemplating changes which result in this outcome, since the proposals seem to run completely counter to the spirit of the recent changes in relation to government refunds for exploration and other costs (changes whose whole purpose was to put the different players in the industry on an equal footing). But it is an outcome which is implied by the consultation itself if the overall effect of the change is revenue neutral, as is stated, then either all companies are neutral to the change (which is unlikely) or there are winners and losers and the new rules represent a shift in the competitive balance.

Features of the new regime

We also believe that there are several key disadvantages with the new regime itself.

Under the current regime, the deductibility of net financial items is determined by reference to balance sheet values. There is certain logic to this treatment, since a company's borrowing capacity will be driven by its oil reserve base, which will also influence the balance sheet values. Marathon believes that familiarity with the existing regime, the thrust of which has remained the same for many years, counters the rules' inherent complexity (which is in any case at its most acute only in certain circumstances). It is accepted that there are anomalies in the existing regime - for example, a net financial items credit could be fully taxed in situations where a net financial items debit would be only partially relieved.

The new rules, in contrast, use a company's undepreciated tax value as the arbitrary yardstick of interest deductibility. This means that after 6 years, the write-off period for tax purposes, there can be no offshore interest deductions (assuming that no subsequent investments have taken place). We agree with the consultation document that the new rules have the advantage of being relatively simple to apply; however, and as a consequence, they do not appear to mirror commercial reality at all closely. We see no reason for assuming that a third party lender would refuse to advance project finance for more than 6 years. In our view, any disallowance of interest expense over and beyond that necessary to restrict interest deductions to an arm's length amount is artificial and not commercial. As an alternative, allowable offshore interest deductions could for example be determined by reference to an arm's length test. The consultation document does not state whether this option was considered, nor, if it was, on what basis it was rejected.

The proposed new regime is regressive. Consider a new project which is to be financed by debt to be repaid out of a percentage of cashflows from the project. Under the base case, it may be that the debt is repaid in full within 6 years, such that a proportion of interest cost is allowed in the offshore regime each year. Under a more pessimistic scenario, it may be that the debt takes longer than 6 years to repay in full, such that no interest at all will be allowed in the offshore regime in the final years (other than the proportion of onshore losses which can be transferred for offset against offshore income subject to general tax). Thus the new rules would perversely apply a higher percentage disallowance of interest expense than in a scenario where returns were higher. Under the current rules, by contrast, the taxpayer would suffer no increase in the percentage of interest disallowed provided that a 20% equity ratio was maintained.

Another anomalous feature of the new regime is that interest expense will be allowed against onshore income to the extent that it is disallowed in the offshore regime. To an offshore-only company such as Marathon, onshore deductions have minimal value (except to the extent that they can be transferred to the offshore). There will be other players for whom onshore losses will be capable of greater use. We do not believe that the tax system should favour companies with onshore activities in this way. Indeed, the exploitation by conglomerates of the onshore/offshore boundary is one of the targets of the proposed changes.

The new regime entails an increase in tax where interest is expensed/debited, but a reduction in tax where interest is received/credited. An anomalous result of these twin changes is that incentives to invest are reduced. An exclusively offshore company with a mature portfolio will be able to put surpluses on deposit to earn interest, on which tax will be paid at up to 28% under the new rules compared with a rate of 78% under existing rules. On the other hand, if the company instead chose to invest those surpluses in a new project, its interest income would be substantially eliminated and it would suffer the new regime's harsher treatment of interest expense. At the margin, therefore, offshore investment will be reduced. This discrimination against companies making new investments is out of step with policies aimed at promoting efficient resource management on the NCS.

Conclusion

Marathon agrees with the Ministry's observations in several areas; overall, however, we are not supportive of the proposals as they stand. In summary, the proposals may bring modest simplification benefits, but at the cost of unacceptable distortions in the tax regime.

We accept that there are weaknesses in the current rules relating to financial deductions. However we consider that the new rules would create more problems than they would solve and would create an unequal playing field. We therefore do not support their implementation. We would welcome the opportunity to discuss the above further with you. If you would like to set up a meeting, or have any questions in relation to the above, please contact Paul Haworth. Paul works in our European Tax group and is based in Marathon's London office where he can be reached on +44 20 7298 2603 or by e-mail to phaworth@marathonoil.com.

Yours sincerely

R.D. Wilson
Managing Director
Marathon Petroleum Company (Norway)

cc Ministry of Petroleum and Energy