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Norwegian tax regime for petroleum exploration - additional information on the reimbursement of the tax value of exploration costs

1 Introduction and summary

We refer to the letter of 18 June 2018 from the EFTA Surveillance Authority (hereafter "the Authority") (Case No 81036, Document No 918760) in which the Authority requests additional information regarding the complaint against the Norwegian tax rule on the reimbursement of the tax value of exploration costs. We also refer to our letters of 22 September 2017 and 9 February 2018.

As argued in our letters of 22 September 2017 and 9 February 2018, the Norwegian Petroleum Tax System (PTS) is the relevant system of reference when evaluating the rules for reimbursement of the tax value of exploration costs under the State Aid rules of the EEA Agreement. The Ministry's response is based on this premise. As further described in the letters, the main objective of the PTS is to secure the state high revenues from the petroleum activity on the Norwegian Continental Shelf (NCS) without distorting the companies' decisions (neutrality). A neutral tax system will not hinder economic profitable activities and does not affect commercial decisions.

The Ministry maintains that the reimbursement of the tax value of exploration costs does not amount to state aid under Article 61 (1) EEA.

The Ministry holds, first, that the reimbursement of the tax value of exploration costs does not confer an "advantage" within the meaning of Article 61 (1) EEA to companies in a tax loss position with exploration costs. In the Ministry's view, the potential economic benefit of tax effects that derive from differences in timing of payments or deductions (for instance depreciation schemes) should be calculated in present value terms. The introduction of the reimbursement rules for exploration costs did not imply an advantage for specific companies (companies in a tax loss position) or costs (exploration costs). The effects of the general schemes under the PTS – the right to carry forward losses with interest and the reimbursement of the tax value of losses when petroleum activities are terminated – ensure the same net present value of tax payments for all petroleum companies and all kinds of costs.

Second, the Ministry submits that the reimbursement rule is, in any event, not selective and that it therefore does not imply state aid under the EEA agreement Article 61 (1). The crux of the selectivity test is whether the measure introduces a distinction between economic operators that are, in light of the objectives pursued by the reference system, in a comparable factual and legal situation, a distinction that is not justified by the nature and general structure of that system.

The reimbursement rule fails to meet the requirements of selectivity for three different reasons.

The first reason is that the reimbursement rule must be regarded as a general measure that apply to all and is open to *all* petroleum companies, provided certain conditions are fulfilled. This is illustrated by the fact that all active petroleum extraction companies incurred exploration costs in 2016 and that a significant majority of petroleum companies in a tax loss position, received reimbursement in 2016. Such a general measure does not confer any selective advantage to those complying with these conditions; *i.e.* those being in a tax loss position and having exploration costs.

The second reason is that companies eligible for reimbursement of the tax value of exploration costs are in a different factual and legal situation relative to companies not eligible for such reimbursement.

As regards the first condition of being a company in a tax loss position, these companies are not in a comparable situation as companies in a tax paying position. Indeed, the introduction of the reimbursement rule for exploration costs further equalised the treatment between those two groups of undertakings, which in turn is part of the objectives pursued by the PTS as the relevant reference framework. Hence, no selectivity exists in this regard.

Nor does the reimbursement rule's limitation to exploration costs confer a *selective* advantage, as there are relevant differences between exploration costs and other cost types. The petroleum activity is characterised by high risk, high upfront costs and significant uncertainty concerning potential or future income. These features are more prevalent for exploration costs than for other cost types. Before the introduction of the reimbursement rule, companies in a tax loss position could face a possible liquidity disadvantage preventing them from starting otherwise profitable exploration activities, and in turn reduce the value creation and revenue from the NCS. Thus, the Ministry maintains that the difference in treatment of costs is in accordance with the objectives pursued by the PTS.

Third in relation to selectivity, on the assumption that the limitations to the reimbursement rule renders the measure *prima facie* selective, the Ministry is of the view that such difference in treatment of certain costs is in any event justified by the nature or general scheme of the system of reference.

The Authority requests information on the tax treatment of costs for *companies in specific phases* of the petroleum activities and different *tax positions.* As a clarification of facts, sections 2 and 3 give a brief overview of fundamental features of the Norwegian petroleum activity and the PTS. Section 4 provides the Ministry's state aid assessment. The Ministry responds to the Authority's specific questions in section 5, to the extent they are not already dealt with under section 4.

2 The petroleum activity - production licenses and structure

2.1 Production licenses - different phases

Before oil and gas can be developed and produced, the resources have to be discovered through exploration. Exploration is thus a necessary *first step* of petroleum activity. Further, exploration is an integral part of a company's petroleum activity, and cannot be seen as a separate activity. In addition to exploring new areas, exploration may take place in or close to already discovered petroleum deposits in development or in production. The aim might for instance be to add resources from areas near already identified discoveries or fields. Exploration costs, for instance the purchase of seismic data, may also incur in relation to an application for a license, the purchase of a license or a petroleum company etc. Thus, exploration is an integrated and necessary part of all petroleum activity. This implies that petroleum companies engaged in extraction activities whether in tax position or not, will normally incur exploration costs.

Petroleum companies engaged on the Norwegian continental shelf (NCS) need a *production licence* to explore, develop and produce petroleum resources (see section 3 in the Ministry's letter of 9 February). Production licenses are awarded by competition, in dedicated licencing rounds arranged by the Ministry of Petroleum and Energy. The production license gives the holder (typically a group of petroleum companies – *the licensees*) the exclusive right and obligation to carry out exploration and production of petroleum resources in the area covered by each license. A production license may contain several petroleum deposits. Thus, the production license covers *all phases* of petroleum activity, and is not merely connected to the exploration, development or the production phase.[1]

According to the Ministry of Petroleum and Energy, 41 companies are today active on the NCS, in 531 production licenses.[2,3] Some of these licenses are in the exploration phase, while many may be in the development, production and the final phase of closure.

Of the 41 petroleum companies, seven companies only have interests in licenses that are *per today* in the exploration phase. The number of companies that only have interests in licenses in the exploration phase may change if a discovery is made and the licensees decide to develop and produce the resources.[4] Such a decision will be done by the group of licensees and based on commercial considerations.

The majority (32 companies) of the 41 companies that are active on the NCS today, hold interests in licenses both under exploration and in production. Only two companies hold today interests in fields that only are in the production phase. These companies are however, relatively new to the NCS.

As the above shows, it is not the *companies,* but rather the *production licenses* that have reached a specific phase of petroleum activity. A number of companies that in their start-up phase focused on exploration, today have interests in licenses covering the entire value chain. These changes have occurred both by the development of discoveries, and through acquisitions/mergers.

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[1] As noted in section 3 in the Ministry's letter of 9 February, after exploration, the licensees must submit a Plan for Development and Operation to the Ministry of Petroleum and Energy. The Ministry of Petroleum and Energy must approve the plan before development can begin.

[2] See map of the active production licenses on the Norwegian Continental Shelf: http://www.npd.no/Global/Norsk/4-Kart/Sokkelkart2017/Kontinentalsokkelkart-2017.pdf

[3] The difference between the number of petroleum companies taxable under PTA in 2016 (71 according to OTO) and the number of active petroleum companies active on the NCS in 2017 (41 according to MPE), is mainly due to mergers, acquisitions and companies leaving the NCS.

[4] Sales and acquisitions of interests in licenses in different phases on the NCS may also affect this number.

2.2 Structure of the petroleum industry - the exploration phase

In a report from 2018, the Norwegian Petroleum Directorate describes the current exploration activities on the NCS:[5]

"As the NCS has become a more mature petroleum province, facilitating a player picture which ensures efficient exploration, development of discoveries and good resource management have been important for the government.

A broad variety of players creates competition, which promotes exploration efficiency. It also ensures a greater diversity of ideas and interest in different play and prospect concepts, and the adoption of alternative technologies and working methods."

Bellona argues in its letter of 28 May 2018 to the Authority, see section 2.1.2, that *"an indication of any favouring of non-taxable exploration activities over taxable exploration activities could be reflected in an overview of which actors are conducting exploration activities now, compared to the years prior to the introduction of the reimbursement scheme."*

Exploration was initially dominated by a limited number of players (licensees, *i.e.* operators and partners), primarily large Norwegian and international companies. The number and diversity of these players has increased from the mid-2000s.

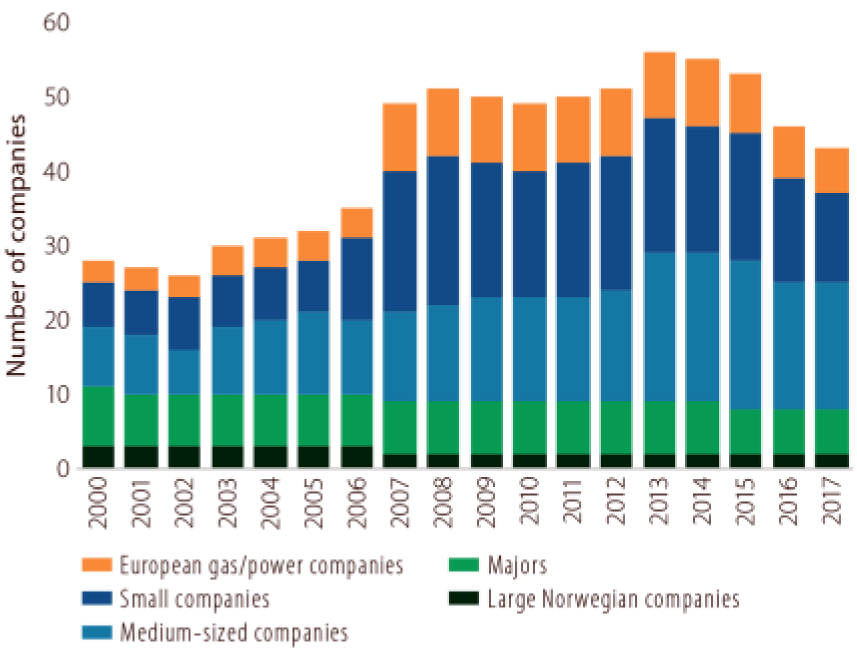

Figure 1: Companies on the NCS, 2000-17.

[5] See http://www.npd.no/en/publications/resource-reports/2018/chapter-5/

A number of factors, apart from the oil price, influences the changes in the company structure on the NCS:

- The petroleum industry, including the companies operating on the NCS, is a global industry. Hence, the structure of the industry is influenced by some common, international trends. In recent years, companies financed by private equity have made substantial acquisitions on the NCS and the UK continental shelf.
- The maturity of the NCS and complexity of the petroleum extraction may also influence the company structure. A more mature shelf, typically with smaller discoveries and more focus on enhanced oil recovery, may lead to fewer oil majors and an increased number of smaller companies.

The tax system may also have an impact on the company structure on the NCS. It should be noted that in the period from 2002 to 2005, the neutrality properties of the PTS were gradually increased, with e.g. increased certainty for deductions and more equal treatment of petroleum companies irrespective of tax position. It had been a concern that a few well-established companies dominated the NCS. The increase in new entrants and smaller companies indicates that after the neutral amendments, the PTS did not represent a barrier for new companies to enter the NCS. Bellona claims (cf. page 12 in the letter of 28 May 2018), that changes in the company structure on the NCS illustrates "*the effect of a provision favouring exploration activities undertaken by non-taxable companies over both exploration activities undertaken by taxable companies, and over other activities governed by the Norwegian petroleum tax system regardless of tax position*." The Ministry disagrees with Bellona on this point. As argued above, the changes in the industry structure on the NCS cannot be explained by one factor alone. Moreover, favouring certain activities or companies is not an explanation factor, as the amendments in the PTS led to *equal* tax treatment of companies on the NCS.

3 The petroleum tax system (PTS) – objective and consolidation

3.1 Objective and neutrality – accrual principle

As described in the Ministry's letters of 22 September 2017 and 9 February 2018, the main objective of the PTS is to secure the state high revenues from the petroleum activity without distorting the companies' decisions (neutrality). A neutral tax system requires *symmetrical* treatment of costs and income, *i.e.* that all costs can be deducted against the same rate as the income is taxed. A neutral tax system will not hinder economic profitable activities, and does not affect commercial decisions (like the choice of which company structure to set up or which business model to choose).

A neutral resource rent tax can be designed as *a cash flow tax*, with immediate deductions of both operating costs and investments (capital expenses). A cash flow tax in its purest form may include an annual pay-out (reimbursement from the state – "negative tax") of the tax value of losses (costs). Alternatively, a neutral resource rent tax may be an *accrued (periodic) tax* where the capital expenses are depreciated over a longer period and deduction of costs first becomes effective when the taxpayer is incurring income. A neutral accrued tax must include features that compensate for the time value loss following from waiting compared to immediate deduction. Such compensation is given as an adequate interest rate on investments and unused losses, keeping the real value of deduction over time. A neutral, accrued tax must also give the taxpayer certainty for the full value of all tax losses in the future.

As the ordinary tax system, the Norwegian PTS is based on the accrual principle. Over time, the PTS has developed towards a more neutral tax regime. As explained in our letter of 9 February 2018, it is especially important with a neutral PTS due to the high tax rate (78 pct.) combined with the particular features of the petroleum activity. Provisions that contributes to the current neutral (accrued) PTS, are the right to carry forward losses with the addition of interest and the right to claim reimbursement from the state for the tax value of any uncovered losses upon the cessation of the petroleum activity (termination reimbursement). These two provisions secures that the state covers 78 pct. of *all* costs (in present value terms) also for companies that are in a tax loss position.

For exploration costs, a cash flow element is also introduced, *i.e.* the annual reimbursement rule. The reimbursement rule implies that a company in a tax loss position may claim the tax value of exploration costs from the state annually, instead of carrying the costs forward with interest. The introduction of the reimbursement rule equalised the treatment of companies in a tax loss position and a tax position, with regard to the timing of deduction for exploration costs. Thus, the reimbursement rule facilitated decision making in groups of licensees consisting of both companies in tax paying position and companies in tax loss position. Putting all companies on equal footing when considering exploration, for instance in neighbouring areas, might have increased the exploration activities on the NCS.

3.2 Consolidation of income and costs – a company's tax position

The PTS is a net income tax system, *i.e.* all relevant costs are deductible before arriving at the tax base. The *petroleum activity* on the NCS is taxed on a *consolidated* level (not field-by-field taxation). Hence, a petroleum company can deduct costs related to one license from income related to other licenses. The company's tax base for the petroleum activity in the income year is the sum (positive or negative) of the income and costs from the total petroleum activity. A company's *tax position* in a specific income year (and whether or not the company is eligible for reimbursement of the tax value of exploration costs that have incurred in that income year) will therefore depend on the result in the different production licenses the company holds in that year. The effect of consolidation is illustrated in Attachment 1.

4 State aid assessment

4.1 Introduction – the measure

The legal basis for the reimbursement rule (the relevant measure) can be found in the PTA Section 3, litra c, fifth Subsection. According to the relevant measure, companies may claim immediate reimbursement of the tax value of exploration costs in connection with the annual tax assessment. The reimbursement claim is limited upwards to the annual loss in the tax year in question, which in effect limits the scope of the measure to companies generating a tax loss that year.

As described in section 3.1 (and previous letters) all petroleum companies on the NCS are secured the real tax value of all deductions through the rules on carry forward of losses with interest and the reimbursement of the tax value of losses when petroleum activities are terminated. These two main elements secure equal tax treatment (in present value terms) between companies in a tax paying position and companies in a tax loss position for all costs. The reimbursement rule for exploration costs (the measure) thus only affect *at what time* the tax value is reimbursed.

In the Ministry's view, the relevant measure neither constitutes an advantage nor is it selective.

First, in section 4.2 below, the Ministry will ascertain that the reimbursement rule, *i.e.* the relevant measure, does not constitute an advantage within the meaning of Article 61 (1) EEA.

Second, in section 4.3 and under the assumption that the Authority nevertheless finds that the measure entails an advantage, the Ministry will provide an assessment of the selectivity condition. From this assessment it will follow that the reimbursement rule, in any event, is not selective, and that it, therefore, also on this basis falls outside the scope of Article 61 (1) EEA.

Based on the Authority's questions, the Ministry provides an assessment of the measure's two limitations in scope, *i.e.* , (1) that the relevant measure only is relevant for companies in a tax loss position, and (2) that the relevant measure does not entitle companies in a tax loss position reimbursement of other cost categories than exploration costs, such as for instance development and production costs.

4.2 Advantage

4.2.1 The notion of advantage – economic benefit

The guidelines on the notion of State aid as referred to in Article 61 (1) of the EEA Agreement (hereafter "the Guidelines") state that: *"An advantage, within the meaning of Article 61 (1) of the EEA Agreement, is any economic benefit which an undertaking could not have obtained under normal market conditions, that is to say in the absence of State intervention."*

The reimbursement rule for exploration costs introduced a cash flow element in the PTS (see section 3.1), with annual reimbursement of the tax value of such costs. The effect of the reimbursement rule is the difference in *timing* of tax deductions for exploration costs, *i.e.* at what time the state covers the tax value through the PTS. The Ministry argues that timing effects under the state aid rules should be evaluated in present value terms (section 4.2.2), and that the reimbursement rule does not entail any advantage under the state aid rules (section 4.2.3).

4.2.2 Economic benefit of timing effects – net present value method

Assessing the potential economic benefit of timing effects can best be done in present value terms. This approach is in line with economic theory of evaluating economic effects of different timing of payments as it takes into account inflation, risk and opportunity costs. Accordingly, in previous state aid cases concerning differences in timing of payments through tax schemes (for instance accelerated depreciation schemes), the economic benefit has been calculated in *present value terms*.

As an example, in 2001, ESA approved accelerated depreciation rules implemented in the PTA for production equipment and pipelines in new large-scale liquefied natural gas (LNG) facilities located in, among others, Finnmark, and the application of these rules to the Snøhvit project, cf. Decision No: 90/02/COL. In this decision, the Authority argued that changing the depreciation period provided lower tax income for the Norwegian state during the three first years, and correspondingly higher income during the next three years. In the Authority's view, this implied a time value loss for the state (a loss in net present value terms) and a corresponding gain for the companies.

The same method was applied in the accelerated depreciation rules for wind power plants, see Decision No: 150/16/COL recital 52, c.f. recital 10. The amendments entailed accelerated depreciation rules, in which the beneficiaries receive deductions in taxable income in advance. The Norwegian authorities calculated the gain for the companies as the net present value of the tax reductions from accelerated depreciations. This calculation was accepted by the Authority as the correct method for assessing the economic benefit of accelerated depreciation of wind power plants.

4.2.3 Economic effect of the reimbursement rule– net present value

The reimbursement rule, *i.e.* the relevant measure, provides for a different timing of deduction for exploration costs. However, the rule does not alter the real value of costs or the level of risk covered by the state. In a situation without reimbursement, a company would carry forward its losses until it runs a profit or it decides to leave the NCS (receiving termination reimbursement). The real tax value of deduction for exploration costs would in both cases be upheld by interest, cf. PTA Section 3 litra c. In other words, the reimbursement rule implies that the company receives an amount today (the tax value of the exploration costs), instead of receiving, *with certainty*, a higher amount in the future (the tax value of the exploration costs with the addition of interest).

As the economic effect of the reimbursement rule is a timing effect, the Ministry holds that a potential economic benefit should be assessed in present value terms.

As illustrated in table 1 in the Ministry's letter of 22 September 2017, the reimbursement of the tax value of exploration costs ensures deduction for exploration costs at the same time for all petroleum companies regardless of the companies' tax position. The reimbursement for exploration costs does not favour companies in a tax loss position compared to companies in a tax paying position, but rather ensures equal timing for deduction of exploration costs for all companies. Hence, there is no effect in present value terms.

Further, the Ministry argues that the reimbursement rule does not imply an advantage in net present terms between categories of costs for companies in a tax loss position. All petroleum companies are secured full tax value of *all costs* through the carry forward with interest and the reimbursement of the tax value of losses when petroleum activities are terminated. The reimbursement rule only affected at what time the state covers the real tax value of the exploration costs.

The Ministry's view is supported by the discussion in a proposition (Ot.prp. nr. 1 (2004-2005)) to the Norwegian Parliament. In the proposition, there is no revenue loss in present value terms associated with the introduction of the reimbursement rule. Hence, the reimbursement rule does not constitute an economic benefit in relation to Article 61 (1) of the EEA Agreement.

Thirdly, the Ministry argues that the reimbursement rule does not alter the level of the state's coverage of risk in a project. Both in a situation without and a situation with the reimbursement rule (the current situation), the state will cover the same share of exploration costs in present value terms (78 per cent), and this implies that the state's share of the overall risk in the project is not altered. Thus, the annual reimbursement of exploration costs does not shift risk from the companies to the state, as claimed by Bellona in letter of 28 May 2018.

Further, the Ministry holds that it lies within the competence of the Norwegian authorities to assess the parameters used to ensure the neutrality properties of the PTS. Based on the Governments assumptions the introduction of the reimbursement rule for exploration costs did not imply an advantage for specific companies (companies in a tax loss position) or specific costs (exploration costs).

4.3 Selectivity

4.3.1 Introduction

As explained in section 4.2, the Ministry maintains that the rule on reimbursement of exploration costs for companies that are in a tax loss position, does not imply any advantage under the state aid rules. If the Authority should, contrarily, find that the reimbursement rule is to be seen as an "advantage" within the meaning of Article 61 (1) of the EEA Agreement, the Ministry is nevertheless of the view that the measure does not favour "certain undertakings or the production of certain goods" and therefore that it is not selective. As a starting point in the selectivity assessment, it should be recalled, as is further explained in the reply below to Question 1 in the Authority's letter of 18 June 2018 , that the Ministry holds that the reimbursement rule is a tax element.[6] Therefore, the assessment of the selectivity condition below relies to a large extent on the case law concerning fiscal (tax) measures.

In section 4.3.2, an overview of the analytical framework applicable to decide the selectivity issue is provided. On the basis of that framework, the substantial assessment is provided for in sections 4.3.3 - 4.3.5, in which the Ministry's response to Question 5 in the Authority's letter of 18 June 2018 will also be provided.

4.3.2 Overview of the selectivity test – the analytical framework applicable

In order to assess whether a tax measure is materially selective, it follows from consistent case law, that a three-step analysis is usually applied.[7] The Ministry is of the opinion that this case is no exception in that regard.

[6] See also section 3.3 in our letter of 22 September 2017.

[7] See for instance the Guidelines on the Notion of Aid (hereinafter "NoA") paragraph 128

The first step is to identify the relevant system of reference.[8] This is an important part, as the reference system constitutes the benchmark against which the selectivity of a tax measure is to be assessed.[9]

Second, after having identified the reference system, one has to consider whether the measure constitutes a derogation from that system insofar as it differentiates between economic operators who, in light of the objectives intrinsic to the reference system, are in a comparable factual and legal situation.[10] Because such a comparison only makes sense against a benchmark, a proper identification of a reference system is, as noted, of crucial importance for the assessment of selectivity.[11] This second step calls for two assessments to be made. First, whether the measure introduces any differences in treatment or whether it is rather a general measure that applies to all and that is open to all. Second, to the extent that there is a difference in treatment, whether those undertakings being treated differently are in comparable factual and legal situations. If there are no differences in treatment or if the economic operators treated differently are not in a comparable situation, in light of the objectives of the reference system, the measure is not selective. If, however, there is a differentiation between comparable undertakings, the measure is *prima facie* selective.

Even if the measure is *prima facie* selective, it is nevertheless considered not selective if the differentiation between comparable undertakings is justified on the basis of the nature or general structure of the system of which the measure form part.[12] This is the third and final step.

Before going into the specific assessment, it should be recalled that where the measure at issue is conceived as an aid scheme and not as individual aid, it is for the Authority to establish that the measure confers that advantage exclusively on certain undertakings or certain sectors of activity.[13] Thus, the Authority carries the weight of the burden of proof in order to demonstrate that the measure is *prima facie* selective, *i.e.* step one and two.[14] With regard to the third and final step, however, there is reversal of the burden of proof to the EEA state.[15]

[8] NoA paragraphs 132-134

[9] See paragraph 4 of the Opinion by Advocate General Wahl in case C-203/16 P *Dirk Andres*

[10] NoA paragraph 135

[11] See paragraph 99 of the Opinion by Advocate General Wahl in *Dirk Andres*

[12] See for instance NoA paragraph 138

[13] See *Dirk Andres* paragraph 84 with further references to case law

[14] T- 399/11 paragraph 50, see also C-279/08 P *Commission v Netherlands (NOx)*, paragraph 62

[15] See *Commission v Netherlands (NOx)*, paragraph 77

4.3.3 The reference system – step one

The reference system usually consists of several legislative provisions that generally apply – on the basis of objective criteria – to all undertakings within that system, which influence the tax burden weighing on those undertakings, including provisions governing the rights and obligations of the undertakings subject to it. This follows for instance from the NoA paragraph 133, and is further supported by case C-203/16 P, *Dirk Andres*, and in particular by paragraph 106-109 of the Opinion of Advocate General Wahl in that case.

As explained in previous correspondence with the Authority, the Ministry maintains that the relevant reference system is the PTS. This is further elaborated in our letters of 22 September 2017 and 9 February 2018. It is, however, worth recalling the basic features of the particular tax design that the PTS is.

The main purpose of the PTS is to *raise revenue* to fund public services and transfers. A further important objective of the PTS is to *maximise the value creation* on the NCS, *i.e.* allowing the state to collect a high share with minimal economic distortions.

According to economic theory, taxes should be designed to keep the economic costs low, and contribute to an efficient use of resources. These principles have been the basis for the design of the Norwegian tax system since the general tax reform in 1992. As noted in the Ministry's letter to the Authority 9 February 2018, the high marginal tax rate for petroleum makes it especially important that the PTS is *neutral*; *i.e.* that it does not distort the companies' investment and operating decisions. An important principle in the design of the PTS is thus, that the tax should not make profitable projects unprofitable after tax.

The Norwegian PTS is based on the accrual principle, see section 3.1. Provisions relevant for the present case, that contribute to a neutral, accrual PTS, are the right to carry forward losses with the addition of interest (PTA Section 3 litra c second Subsection) and the right to claim reimbursement from the state for the tax value of any uncovered losses upon the cessation of the petroleum activity (PTA Section 3 litra c fourth Subsection). These provisions are inherent in, and constitute important elements of, the reference system, as they apply generally – on the basis of objective criteria – to all undertakings falling within its scope, they define the rights and obligations of the undertakings subject to it, cf. NoA para. 133. Moreover, these basic provisions in the PTS are specifically designed to contribute in different ways to the achievement of the main purposes of the PTS.

4.3.4 The comparability test – step two

4.3.4.1 The legal test

It is settled case law, that the assessment of the selectivity condition requires a determination of whether, under a particular legal regime, a national measure is such as to favour 'certain undertakings or the production of certain goods' over other undertakings which, in the light of the objective pursued by that regime, are in a comparable factual and legal situation and who accordingly suffer different treatment that can, in essence, be classified as discriminatory.[16] If those who benefit from the tax measure at issue and those who do not benefit from it are not in a comparable factual and legal situation from the point of view of the objective pursued by the normal regime, the measure is not selective.[17]

There are, accordingly, two assessments to be made:

First, whether there is a difference in treatment, or whether, alternatively, the measure is a general measure applicable to all economic operators. Indeed, even tax measures that are not aimed at one or more specific recipients defined in advance, but rather based on objective criteria according to which it may be granted, may be selective.[18] However, the mere fact that only taxpayers satisfying the conditions for the application of a measure can benefit from the measure does not, in itself, make it a selective measure.[19] As will be further explained in section 4.3.4.2 below, the Ministry is of the view that the reimbursement rule, including the conditions for the application of it, does not introduce a difference in treatment, as it applies to all petroleum companies.

Second, in the event that the measure is *not* a general measure, one has to consider whether the differentiation is nevertheless warranted by any relevant factual or legal differences between the undertakings. In *Dirk Andres*, the ECJ stated in paragraph 89 that the assessment depends on the prior definition of the legal regime in the light of whose objective it is necessary, where applicable, to examine whether the factual and legal situation of the undertakings favoured by the measure in question is comparable with that of those which are not." In that sense, the objectives on which the reference

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[16] See for instance joined cases C-20/15 and 21/15 *World Duty Free* paragraph 54, with further references the case lawand *Dirk Andres* paragraph 83.
[17] See for instance footnote 48 of the Opinion by Advocate General Wathelet in *World Duty Free*, with further references to case C 78/08 to C 80/08, *Paint Graphos* paragraphs 63 and 64 and case C 417/10, *3M Italia* paragraph 42.
[18] See for instance NoA paragraph 117
[19] See for instance *World Duty Free* paragraph 59, with reference to *3M Italia*, paragraph 42

system relies constitute *legitimate grounds* or *permissible goals* for a difference in treatment.[20]

As will be further explained in sections 4.3.4.3 and 4.3.4.4 below, the Ministry is of the view that (i) companies in a tax loss position and companies in a tax paying position are not in comparable legal positions, and that also (ii) companies in a tax loss position with exploration costs and companies in a tax loss position generated by other cost categories, are not in comparable factual positions.

4.3.4.2 First part – is there a difference in treatment or is it a general measure?

The question here is whether the two conditions – tax loss position and exploration costs – entails a difference in treatment, or whether the fact that only taxpayers satisfying those conditions does not call into question its general nature.

The Ministry is of the view, therefore, that the fact that the right to claim reimbursement is based on certain conditions, and that only those companies satisfying those conditions can claim such reimbursement, does not, in itself, make it a selective measure.[21]

First, with regard to the condition that only undertakings in a tax loss position are eligible to claim reimbursement, it should be noted that that condition does not relate to certain inherent properties specific to companies.[22] It only relates to the economic situation that the petroleum companies are in at a given point in time. Petroleum companies at a certain point in time may have production licenses in different phases (exploration, development or production phase), have different portfolios of license interests, and have variable success in their exploration activities. These are factors that affect a company's tax position, and the need of carrying out exploration activities in a specific income year, and thus if the company is subject to reimbursement of exploration costs. As such, depending on several factors, any petroleum company may at any given time be in a tax paying position or in a tax loss situation. The fact that the reimbursement rule is only applicable to petroleum companies that in a given tax year find themselves to be in a tax loss position, does not therefore call into question the general nature of the measure.

Second, with regard to the condition that reimbursement may only be claimed for exploration costs, it should be noted that this is connected to certain *costs* in the

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[20] According to NoA paragraph 135 "[e]xternal policy objectives – such as regional, environmental or industrial policy objectives – cannot be relied upon by the EEA State to justify the differentiated treatment of undertakings" , as that difference can only be explained by reference to "the intrinsic objective of the system of reference".

[21] See for instance *World Duty Free* paragraph 59 and *3M Italia* paragraph 42

[22] See also paragraph 100 of the GC's judgment in *Netherlands Maritime Technology Association*

petroleum activity (exploration costs), and not certain *companies* «in the exploration phase».[23] The Ministry holds that the reimbursement rule is applicable to all petroleum companies, and that all petroleum companies therefore are potentially eligible for reimbursement of the exploration costs in a specific income year. The reimbursement rule is therefore a general measure.

This is also supported by case law. Reference is first of all made to case C-100/15 P, *Netherlands Maritime Technology Association*, which concerned a Spanish tax scheme that, on certain conditions, allowed for an early depreciation of certain assets acquired through financial leasing. The ECJ found that the measure was applicable to all the companies subject to income tax in Spain, and therefore not selective, the ECJ emphasised that all kinds of assets could be financed through leasing contracts.[24] And, moreover, the fact that the tax advantage in question was restricted to situations where companies made use of a leasing contract – and did not accordingly apply to other forms of financing – did not either make the measure selective.

That finding should be even more evident in the present case. While the condition concerning the use of a leasing contract is indeed open to all, as every company may freely opt to make use of such a financing method, the Ministry submits that incurring exploration costs is a much more inherent element in the petroleum activity.

First, all petroleum companies that have been awarded a production license comprising oil or gas resources that per today are under development or production, were obliged through a binding work programme to carry out exploration activities and hence, *must* have incurred exploration costs in an earlier phase in order to discover petroleum.

Moreover, as explained in section 2, petroleum companies typically have interests in several licenses in different phases. Thus, a petroleum company with a field under development or production will in most situations incur exploration costs for instance in another license that is in the exploration phase.

In addition, as also explained in section 2, companies holding interests in licenses with fields under development or production, may also incur exploration costs, and be in a tax loss position (cf. consolidation of income and costs). Such exploration costs may for instance even be generated in licenses with producing fields, when the companies active under those licenses decide to explore neighbouring areas of the producing field.

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[23] As explained in the Ministry's letter 9 February 2018, the costs must be exploration costs "in their nature" to be reimbursable. Only (direct and indirect) costs sufficiently connected to a company's exploration, *i.e.* activities with the purpose of finding petroleum reserves in a defined part of the NCS, are deemed to be exploration costs in their nature.

[24] See GC's judgment in case T-140/13 *Netherlands Maritime Technology Association*, paragraph 28

Thus, the significant share of the petroleum companies has several licenses that are at different stages, usually involving both exploration costs and other costs. The share of exploration costs in total costs will for all these companies also evolve over time as the activities continue in different licenses.

For the sake of clarity, it should also be noted that a company in a tax loss position with costs related to exploration activities will be eligible for an annual tax reimbursement for exploration costs incurred in the income year, even if the company also has an interest in a license in the production phase, see example in table 1 in Attachment 1.

In sum, therefore, the Ministry maintains that the act of incurring exploration costs is even more general than the act of financing an asset by a leasing contract.

A new company on the NCS that is awarded one or more interests in production licenses, will only have interests in licenses in the exploration phase. However, this will change if a discovery is made and developed in one of its licenses. The production license that the companies are awarded from the MPE gives the licensees an exclusive right to carry out all the stages of the petroleum activity, from exploration and through the chain up to, and including, the sale of petroleum (and the closure phase).

Indeed, at any given time there may also be some companies that have not incurred exploration costs, for instance if they have acquired an interest in a license, which at that point already are in the development or production phase. However, as it follows from section 2.1 above, all active petroleum extraction companies subject to the PTS incurred exploration costs in 2016. The Ministry assumes that even companies that at a given time only hold licenses in the development or production phase, will not refrain from participating in the exploration of neighbouring areas of the developing or producing field. Thus, even these companies will necessarily incur exploration costs as the areas around that field are being explored.

Moreover, as noted above in section 2.1, there are *per today* seven companies that have interests in licenses that are in the exploration phase *only*. Even these companies that only hold interests in licenses in the exploration phase, will however also have costs that are not exploration costs "in their nature", and therefore not eligible for annual reimbursement.[25]

In this regard, the Ministry again refers to *Netherlands Maritime Technology Association*. In that case, it seems as though the measure *de facto* mainly promoted the construction of vessels in Spanish shipyards. Nevertheless, the GC stated in paragraph 100 that "a different tax burden resulting from the application of a 'general' tax regime

[25] Such costs will be carried forward with interest under the general rules for tax losses.

is not sufficient on its own to establish the selectivity of taxation".[26] Moreover, in paragraph 96 it is stated that "the conditions which must be met … refer to a category of assets which is open and indeterminate and which may include, but is not limited to, vessels" and that it "therefore [was] no need for the Commission to determine specifically whether the notified measure favours shipyards or shipping companies." This judgment was, as noted above, also upheld by the ECJ.

Moreover, reference could also be made to the case C-75/97 *Belgium v Commission*, concerning the question whether increased reductions in social security contributions constituted selective state aid. While referring to a previous version of the 'Maribel bis/ter' scheme, in which a reduction in the amount of social security contributions was provided for all undertakings employing manual workers, Advocate General La Pergola stated in paragraph 9 that "[c]onstrued in this way, the Maribel scheme of 29 June 1981 was based on provisions which could be considered general, as all undertakings without discrimination were permitted to benefit from the reduction in contributions, subject to the conditions set out in the Law."

Indeed, while this condition may also have different effects on different companies, depending on whether they are labour-intensive businesses or not, *i.e.* the choice of business model, it is clear that such a condition is non-selective.

This applies, it is submitted, even more so with regard to the exploration cost condition. As noted above, all petroleum companies, irrespective of business model, will incur exploration costs and, therefore, also be eligible to claim reimbursement.

On the basis of all the above, the Ministry maintains that the reimbursement rule is a general measure applicable without distinction to all economic operators within the reference framework, and therefore it does not entail any difference in treatment for the purpose of Article 61 (1). The rule on reimbursement of exploration costs is applicable to *all companies* that hold an interest in a production license on the NCS, *i.e.* irrespective of the phases of the production licenses in the company's portfolio, and all companies will, irrespective of their business model, to a greater or lesser extent, incur exploration costs. Thus, all petroleum companies are potentially eligible for reimbursement of the exploration costs in a specific income year, and the Ministry holds, therefore, that the reimbursement rule is a general measure.

4.3.4.3 Second part – comparability of companies in a tax paying position vs. companies in a tax loss position

In the event that the Authority, despite the assessment above, finds that the reimbursement rule does not constitute a general measure applicable to all petroleum

[26] Case T-140/13 *Netherlands Maritime Technology Association*.

companies, but rather finds that it introduces a differentiation in treatment, the measure would still be non-selective if the undertakings being treated differently are not in comparable situations.

As this assessment is based on the condition that the Authority somehow finds a difference in treatment, all the Ministry's arguments here are of secondary nature. Moreover, such a differentiation may be the result of either (i) the difference between companies in a tax loss position and companies in a tax paying position, or (ii) the difference between exploration costs and other costs. The question here (section 4.3.4.3) concerns the first alternative, *i.e.* whether companies in a tax loss position and companies in a tax paying position are not in comparable factual and legal positions, in light of the objective on which the PTS relies. The second alternative will be addressed in section 4.3.4.4 below.

In order to provide the Ministry's view on this, it is useful to start with the situation *before* the reimbursement of the tax value of exploration costs was introduced. The Ministry holds that before the reimbursement rule existed, petroleum companies recording a loss were not *in a similar factual and legal situation* as petroleum companies with positive taxable income. For companies in a tax paying position, the deduction of costs will reduce the tax payment each year while companies in tax loss position have to carry the losses forward. Even though companies in a tax loss position have the right to carry forward losses in subsequent years without time limit, and even with the addition of interest so that the losses do not lose value over time, certain companies could face a potential liquidity disadvantage. Before the reimbursement rule was introduced, such companies could have a tax incentive to purchase a share in producing licenses, with the aim of entering a tax paying position. Tax-motivated transfers of production licenses that are not based on pure commercial considerations may, however, reduce the value creation from the petroleum activity on the NCS, and therefore contradicts an important objective of the PTS.

These differences between companies in a tax loss position and companies in a tax paying position thus warranted the adoption of the annual reimbursement of exploration costs for companies not in a tax paying position, and in the view of the Ministry, these differences also render the measure not selective.

This is also supported by case law. In the *Paint Graphos* case, the Court was faced with the task of classifying a special regime for cooperative societies for state aid purposes, in which the income of those operators was exempt from corporate tax. The ECJ found that the exemption from income tax for cooperative societies was not selective, as the cooperative societies were not comparable to commercial companies.

The main objective of the reference system (income tax system) was to generate public revenue. As the cooperative societies could generate profits, and therefore also could have contributed to the overall aim of the corporation tax, one could have argued from a purely formal point of view, and in light of the main objective of the reference system, that cooperative societies were indeed in a comparable situation to commercial companies, and that the measure consequently was selective.

The ECJ, however, did not follow a formalistic approach, but rather undertook a material analysis of the characteristics of cooperative societies compared to commercial companies, and pointed out *inter alia* that the profit margin of this particular kind of company was considerably lower than that of capital companies.[27]

The Ministry would argue that there are even stronger reasons for the finding of non-selectivity in the present case than in the *Paint Graphos* case.

In the *Paint Graphos* case, the differences between cooperative societies and commercial companies, with regard to the main objective of the reference system, were merely a matter of degree – the profit margin of cooperative societies was lower, the access to equity was more limited etc. The difference between companies in tax loss and tax paying position is, however, a matter of "either or" – either the companies are in tax paying position in which they may deduct costs immediately, or the companies are in a tax loss position according to which they may not avail themselves of the possibility to deduct costs immediately. This is a direct and inherent consequence of a net income tax system.

Moreover, the outcome of the exemption in the *Paint Graphos* case and the outcome of the reimbursement rule is also materially and importantly different. In the former case, the outcome was clearly that cooperative societies did not have to pay income tax, in contrast to the commercial companies, putting the commercial companies at a relative disadvantage, while in the present case both companies in a tax loss and tax paying position will receive tax reimbursement of exploration costs of the same value and at the same point in time, on the basis of the reimbursement rule and the ordinary deduction rule, respectively. The outcome is the same for those companies, the only difference is the measure on which these companies have to rely on in order to achieve that outcome.

The reimbursement rule, in essence, fills the void for the companies in a tax loss position that follows from the simple fact of net income tax systems that the ordinary right to deduct costs is only immediately effective for companies in a tax paying

[27] Joined Cases C-78/08 to C-80/08, *Paint Graphos* paragraph 50-51 and paragraph 61. See also NoA section 5.4.1.

position. Companies in a tax loss position may not avail themselves of that possibility, as they *per se* do not have any income where their costs can be deducted.. Those situations – being in a tax paying and tax loss position – are not considered comparable.

In his opinion in *World Duty Free* Advocate General Wathelet stated in paragraph 94 that the selectivity criterion "covers tax measures which, irrespective of the techniques used, have the effect of imposing a differentiated tax burden on undertakings which are in a comparable factual and legal situation." In this perspective, it is important to note that the right to claim reimbursement of exploration costs for companies in a tax loss position and the possibility to immediately deduct costs in income for companies in a tax paying position are complementary rules, ensuring that those companies are treated equally (to the extent that the reimbursement rule applies for exploration costs, see below). The reimbursement rule does not, therefore, have the effect of imposing a differentiated tax burden on undertakings. Rather, it contributes to increased equality.[28]

Based on the above, the Ministry maintains that any difference in treatment between companies in a tax paying and tax loss position is warranted, as those situations are not factually and legally comparable. The fact that the reimbursement rule only applies to companies in a tax loss position does not therefore make it a selective measure within the meaning of Article 61 (1) EEA.

4.3.4.4 Second part – comparability of exploration costs vs. other costs

The assumption here is that the Authority has found that the reimbursement rule entails a difference in treatment, and the differentiation is the result of the condition that only exploration costs may be reimbursed. On those assumptions, the question here is whether companies in a tax loss position with exploration costs and companies in a tax loss position generated by other costs, are in comparable legal and factual situations.

The Ministry is of the view that petroleum companies without taxable income and with costs that are not related to exploration, are not regarded as being *in a similar factual and legal situation* as petroleum companies without taxable income and with costs related to exploration. In light of the different nature of these costs, as will be explained below, the measure is not selective.

As an introductory remark, it should be recalled, as explained in section 2.1, that all active petroleum extraction companies subject to the PTS incurred exploration costs in

[28] The aspect of tax equality will be further elaborated below in section 4.3.5, concerning the justification of the measure on the basis of the logic of the system.

2016. This clearly suggests that no petroleum company has a business model according to which no exploration cost will be incurred. It is likely that even companies that at a given time only hold licenses in the development or production phase, will not refrain from participating in the exploration of neighbouring areas of the developing or producing field. Thus, even these companies will necessarily incur exploration costs as the areas around that field are being explored. Moreover, even those companies that carry out exploration activity *only*, will also have costs that are not exploration costs "in their nature", and therefore not eligible for annual reimbursement. Consequently, there are no real clear-cut cases of companies that only incur exploration costs and companies that never incur exploration costs due to any business model. Therefore, the Ministry holds that it is incorrect to frame the selectivity assessment on the assumption that there are companies that only incur exploration costs and companies that never incur explorations costs.

Exploration will typically have a significant *geological* risk, *i.e.* the chance of making an oil and gas discovery. Historically, the commercial discovery rate of exploration drilling has been in the order of 30 per cent on the NCS. Typically, exploration wells have been drilled in approximately 25 per cent of the awarded licenses on the NCS. After each phase in which the work program has been completed, licensee groups reach a mandatory decision-point where they are required either to relinquish the license or to continue with the next phase. For many licenses, the petroleum companies do not discover commercially viable petroleum sources. Further, from the start of exploration activity, it will typically take several years before a potential discovery is made, and additional years before development and production can begin.

Exploration of petroleum is thus characterised by high up-front costs, high risk and potentially a long lead time until the company reaches a tax paying position.

For companies with taxable income, exploration costs are deducted immediately and reduce the taxable surplus in the income year. However, companies in a tax loss position can, for obvious reasons, not avail themselves of that possibility. Indeed, such companies could carry losses forward, until they would gain sufficient profits to fully deduct their losses. In the meantime, however, these companies could face a possible *liquidity disadvantage* preventing them from starting otherwise profitable projects. That would in turn also have negative effects for the objectives of the PTS, which is to raise public revenue and to maximise the value creation on the Norwegian continental shelf. Moreover, the Ministry also submits that the limitation of the reimbursement rule to exploration costs is in line with those basic objectives. The uncertainty (risk) inherent in exploration costs is not comparable with the financial risk associated with development projects, as argued by the complainant. For a project in the development phase, the companies have made a commercial discovery, and the potential uncertainty is therefore mainly limited to future prices and costs, and hence more comparable to risks associated with other investment projects.

The view that these situations are not comparable, is in the Ministry's opinion also supported by case law. Case C-417/10 *3M Italia* concerned the adoption of a tax provision according to which tax proceedings pending before the national court, which have lasted for more than 10 years since the action was brought at first instance and in which the tax authorities have been unsuccessful at first and second instance, could be concluded in return for payment of a sum equivalent to 5 pct. of the value of the claim, in order to ensure compliance with the reasonable time requirement in Article 6 (1) of the ECHR.

The ECJ reiterated settled case law and stated that the fact that only taxpayers satisfying the mentioned time and result conditions could benefit from the measure, could not in itself make it a selective measure. Further, the ECJ emphasized that persons unable to claim its benefit were not in a comparable factual and legal situation to those taxpayers from the point of view of the national legislature's objective of ensuring compliance with the principle that judgment must be given within a reasonable time, see paragraph 42. Thus, when considering in light of which objectives the difference in treatment could be viewed, the ECJ relied on the rather specific objective of ensuring compliance with the principle that judgment must be given within a reasonable time. Finally, a requirement to submit an application within a period of 90 days was considered inherent to measures of this kind, and sufficient to enable all taxpayers to whom the measure applied to seek to benefit from it, see paragraph 43.

The purpose of the introduction of a right to claim reimbursement of exploration costs was to address the possible liquidity challenges that might arise from the inherent characteristics of exploration (high up-front costs, high risk and long lead time to possible income). This in turn increases equality between petroleum companies, in the sense that the tax system does not distort the companies' investment and operating decisions, which is particularly important for the petroleum industry given the high marginal tax rate. The reimbursement rule would in such a case also contribute to the achievement of the principle that the tax system should not prevent economically profitable projects. As noted above, however, for these purposes, exploration costs and other costs are not comparable.

Finally, it should be recalled that the PTS is, in principle, an accrued (periodic) tax system. To introduce reimbursement for the tax value of all costs would break with the accrual principle on which the PTS is based. In practice, it would mean to introduce a pure cash flow tax with annual reimbursements of the tax value of the petroleum companies' total losses (costs and investments) To introduce a pure cash flow system would imply a major redesign of the tax system for the petroleum activity, and would require a broad assessment from the Norwegian Authorities. Moreover, it would go further than required by the reason for a reimbursement rule, *i.e.* eliminating the potential liquidity disadvantage for companies with exploration costs. Thus, the Ministry holds that the introduction and limitation of the reimbursement rule is in harmony with the overall aim of the PTS. Based on the above, the Ministry maintains that any difference in treatment between exploration costs and other costs is warranted, as those costs are inherently different from the point of view of the PTS. The fact that the reimbursement rule only applies to exploration costs does not therefore make it a selective measure within the meaning of Article 61 (1) EEA.

4.3.5 Logic of the system – step three

The assumption here is that the Authority has, despite the reasoning above, found that the reimbursement rule introduces a differentiation between companies that, in the light of the objectives of the PTS, are in comparable factual and legal situations.

It follows from settled case law that a *prima facie* selective measure may still be considered non-selective if it is justified by the nature or general scheme of the tax system. As noted in NoA paragraph 138, that would be the case where the measure derives directly from the intrinsic basic or guiding principles of the reference system or where it is the result of inherent mechanisms necessary for the functioning and effectiveness of the system.

Similarly, under the previous Commission notice on the application of the state aid rules to measures relating to direct business taxation, it followed from paragraph 23 that the differential nature of some measures was non-selective in the case of "measures whose economic rationale makes them necessary to the functioning and effectiveness of the tax system." The basis for a possible justification could, for instance, be the principle of tax neutrality, see NoA paragraph 139.

On the other hand, external policy objectives, which are not inherent to the system, do not constitute a legitimate ground for justification.[29] In *Paint Graphos* the ECJ explained in paragraph 69 that "a distinction must be made between, on the one hand, the objectives attributed to a particular tax regime and which are extrinsic to it and, on the other, the mechanisms inherent in the tax system itself which are necessary for the achievement of such objectives", and in paragraph 70 it affirmed that "tax exemptions

[29] See also NoA paragraph 138 For instance, measures adopted on the basis of a regional development or social cohesion policy is not sufficient in itself to justify that measure, see e.g. case C-88/03 *Portugal v Commission* paragraph 82

which are the result of an objective that is unrelated to the tax system of which they form part cannot circumvent" the state aid prohibition.

The question here is thus whether the reimbursement rule, including the two conditions for the application of it – tax loss position and exploration cost – could be justified by the nature or general scheme of the tax system, *i.e.* whether the measure derives directly from the intrinsic basic or guiding principles of the reference system or where it is the result of inherent mechanisms necessary for the functioning and effectiveness of the system.

As explained in more detail above, the reimbursement rule was adopted to address the potential liquidity challenges petroleum companies otherwise might have faced when incurring exploration costs. The reimbursement of the tax value of exploration costs must be seen in light of the high risk associated with such costs, and the potential liquidity challenges that petroleum companies otherwise could have faced. This could also prevented them from starting otherwise profitable projects, which in turn also would have had negative effects to the main objectives of the PTS which are to raise public revenue and to maximise the value creation on the Norwegian continental shelf.

The adoption of the reimbursement rule for exploration costs reduced these potential *disincentives* to explore for companies that were not in a tax paying position. Moreover, with the option of reimbursement, all companies receive effective deductions for exploration costs at the same point in time (and at the same value). Hence, since the reimbursement rule for exploration costs *equalised* the treatment for tax purposes, the rule is in line with a *neutral* PTS.

The Ministry is of the view that both tax neutrality and the reduction of possible liquidity disadvantages is in line with the logic of the PTS, and that both objectives are therefore, on a separate basis, capable of justifying the measure.

First, as regards the tax neutrality objective, it follows from the description in section 4.3.3 above, that tax neutrality is one of the basic principles on which the PTS relies. Due to the high marginal tax rate for petroleum it is especially important that the PTS is neutral; *i.e.* that it does not distort the companies' investment and operating decisions. As explained above in sections 3.1 and 4.3.3, an important principle in the design of the PTS is that the tax rules should not prevent economically profitable projects. Further, tax neutrality is specifically mentioned in the NoA paragraph 139 as a possible basis for justification. The Ministry holds that the reimbursement rule, which precisely has the effect of increasing equality as regards the timing of costs and reduce potential liquidity disadvantages, thus derives directly from the intrinsic basic or guiding principles of the reference system and constitutes inherent mechanisms necessary for the functioning and effectiveness of that system.Second, as regards the reducing of any liquidity disadvantages, the Ministry submits that as those possible liquidity challenges otherwise could have prevented profitable projects, and in turn reduced the public revenue and value creation on the Norwegian continental shelf, this measure also derives directly from the intrinsic basic principles of the PTS, see paragraph 138 and 139 of the NoA. Moreover, both conditions on which the right to reimbursement is based, are intended to and have the effect of limiting that right to those situations to which the rule was intended to apply, *i.e.* the situations where petroleum companies may face liquidity challenges. Those conditions are therefore necessary elements of the measure in order for it to achieve its purpose, and to ensure that it does not go beyond what is necessary. In that regard, it should be recalled, as explained in more detail in section 4.3.4.4 above, that the uncertainty (risk) in the exploration phase is not comparable with the financial risk associated with development projects, as argued by the complainant. For a project in the development phase, the companies have made a commercial discovery, and the potential uncertainty is therefore mainly limited to future prices and costs.

It follows from the above that the reimbursement rule relies on basic objectives that are inherent in the PTS as such, and it is moreover a necessary measure in order to achieve the purpose of that scheme, while at the same time limited to what is deemed necessary in order to achieve those objectives. The measure is, therefore, justified on the basis of the nature or the general scheme of the petroleum tax system.The above considerations are, in the Ministry's view, also supported by case law. First, in case C-100/15 P, *Netherlands Maritime Technology Association*, described above, the ECJ held that a Spanish tax scheme that allowed, on certain conditions, for an early depreciation of certain assets acquired through financial leasing, was a non-selective measure. Those conditions were aimed at limiting the possibility of early depreciation to cases where the lessee was required to pre-finance the asset and therefore bear the financial cost of the asset before it became operational. Due to the very substantial cost of pre-financing required for the construction of these assets, those restrictions were justified by reason of the nature and internal logic of the Spanish tax system.[30]

Reference could also be made to case C-417/10 *3M Italia*, as also described above, where the ECJ found that the requirement to submit an application within a period of 90 days did not make the measure selective, as that requirement was inherent to measures of this kind, and sufficient to enable all taxpayers to whom the measure applied to seek to benefit from it, see paragraph 43.

[30] See GC's judgment in case T-140/13 *Netherlands Maritime Technology Association* § 29

As it follows from the abovementioned cases, conditions to such measures that have the effect of limiting the measure to those situations which in the first place called for the adoption of the measure, does not make that measure selective. In *3M Italia*, the right to early conclusion of tax proceedings against a payment of 5 pct. of the tax claim value was conditioned upon a minimum length of the tax proceedings and an application within certain time-limits, but both conditions were necessary for that measure to fulfil its purpose to ensure compliance with the reasonable time requirement in Article 6 (1) of the ECHR. Similarly, in *Netherlands Maritime Technology Association*, the conditions on the right to early depreciation were intended to and had the effect of limiting the possibility of early depreciation to those cases where a very substantial cost of pre-financing was required before the asset became operational, *i.e.* the situations that the early depreciation rule was intended to address in the first place.

In the view of the Ministry, a similar line of reasoning is also applicable to the present case. Both conditions – the limitation of the right to reimbursement to companies in a tax loss position and the limitation of the right to reimbursement to exploration costs – are intended to and have the effect of limiting that measure to those situations to which it was intended to apply, *i.e.* the cases where petroleum companies may face liquidity challenges.

Finally, as noted above in section 4.3.3, to introduce reimbursement for the tax value of *all* costs would break with the accrual principle that the PTS is based upon. In practice, it would mean to introduce a pure *cash flow tax* with annual reimbursement of the tax value of the petroleum companies' total losses , and therefore contradict with the Norwegian legislator's fundamental choice of tax design.

Based on the above, the Ministry holds that the reimbursement rule, including the conditions for benefiting of that rule, is justified by the nature or general scheme of the tax system.

5 The Authority's questions in the letter of 18 June 2018

Question 1:

"Bellona refers to the general prohibition of tax pledging pursuant to the Tax Payment Act. In that regard, Bellona states that the annual cash refund is exempt from the prohibition, hence, it is allegedly not a tax claim. Please provide your views on this allegation."

As explained in our letter of 9 February 2018, the Ministry underlines that the claim for reimbursement of the tax value of exploration costs is an integrated part of the PTS and a genuine tax element. The tax value of the reimbursement is determined on the basis of the tax rates applicable for the income year in which the exploration costs are incurred. Further, the size of the payment is set by the Norwegian Tax Authorities (OTO) and the reimbursement of the tax value is treated and paid out as an integrated part of the annual assessment and the tax settlements for the petroleum companies. We also refer to the description in section 3.1. above on how a neutral resource rent tax can be designed as a cash flow tax with annual reimbursement of the tax value of costs. The Ministry thus disagrees with Bellona that the annual reimbursement of exploration costs is not "in its nature" a tax element, as claimed in letter to the Authority 28 May 2018.Further, petroleum tax is comprised by the general rules of the Tax Payment Act (TPA), cf. the TPA Section 1-1 first Subsection, cf. second Subsection litra d.[31] The annual reimbursement of the tax value of exploration costs was a new cash flow element of the PTS with the aim to ensure an equal treatment of companies within the PTS, see section 3.1 above. The introduction of this rule in the PTA in 2005, raised some questions regarding the application of the general rules of the TPA. As regards the general prohibition under the TPA to pledge tax claims, the Ministry concluded that this restriction also covered annual claims for reimbursement of the tax value of exploration costs. To allow petroleum companies to pledge the claim for reimbursement, an exemption was enacted. Thus, under Section 10-1 third Subsection of the TPA, a petroleum company is allowed to pledge the claim for reimbursement of the tax value of exploration costs[32]. This is an exemption from the general rule in Section 10-1 second Subsection of the TPA which states that a taxpayer is not allowed to pledge tax claims.

According to the preparatory work, cf. Ot.prp. nr. 1 (2006-2007), the objective of this exemption for the claim on reimbursement of the tax value of exploration costs, was to contribute to a more equal treatment of petroleum companies. At the time of exploration, companies that are not in a tax paying position also have to fund the tax value of the exploration costs. Without the possibility to pledge the tax claim, it was argued from the industry that such companies could have limited access to capital, and the interest rate could be higher. (Even with the introduction of the reimbursement of the tax value of exploration costs, there is a liquidity disadvantage for companies not in a tax paying position. A company in a tax paying position pays one half of the anticipated taxes for the income year, in the income year (the year the exploration costs are incurred), cf. the TPA Section 10-22 (Instalment tax). The liquidity effect may therefore occur in the income year. A company not in a tax paying position, that claims

[31] Before the new TPA came into force, the legal basis was the PTA Section 7 and Section 8.
[32] When the rule was introduced in 2007, it was placed in the PTA Section 3 litra c fifth paragraph, but moved to the new TPA when this act came into force.

reimbursement of exploration costs, does not receive the tax reimbursement until the tax settlement is finished in the year after the income year.)

The Ministry holds that the fact that an exemption from the general rule for tax claims in the TPA was required, underpins that the claim for reimbursement of the tax value of exploration costs in its nature is a tax claim ("negative tax"). The Ministry maintains that the claim for the reimbursement of the tax value of exploration costs constitutes a tax element and that the three-step-analysis test applies.

Question 2:

"In addition, the Authority would like to know if the pledging possibility exists also for companies in the development or production phases, which do not receive the cash refund, but simply carry forward losses."

As described in section 2, it is not the petroleum company, but rather the *license*, that is in the development or production (or exploration) phase. The majority of the petroleum companies on the NCS have interests (*i.e.* are licensees) in a number of licenses that are in different phases, see above, and can hence consolidate income from the different licenses.

The pledging possibility (for the claim on reimbursement of the tax value of exploration costs) applies to all petroleum companies that are in *a tax loss position*, and have incurred *exploration costs* related to one of their licenses in the income year. Thus, *any* petroleum company can claim reimbursement of the tax value of exploration costs incurred in the income year, and pledge this claim, if the company is in a tax loss position. This is the case also if the company holds an interest in one or more licenses that have reached the development and/or the production phase.

Question 3:

"Pursuant to the Petroleum Tax Act, if a company has losses carried forward when its exploration activities are terminated, these losses can be sold or transferred to another company, or alternatively the company could receive a cash refund. Do these possibilities apply also to companies in the development or production phases?"

Petroleum companies typically have more than one production license. The company's petroleum activity includes all production licenses, and income and costs related to the licenses are taxed on consolidated basis, see section 2. Although companies may have licenses in only one phase (e.g. exploration), the companies will more often have several participation interests in licenses in different phases of the production cycle.

The possibility to sell or transfer a tax loss to another company when the petroleum activity is sold, or when two petroleum companies are merged, cf. the PTA Section 3 litra c third Subsection, applies to all petroleum companies. Thus, it applies irrespective of the phase of the production licenses and company's petroleum activity.

Further, the possibility to claim a refund of an uncovered loss from the state upon termination of the petroleum activity, applies to all companies ceasing their activity on the NCS.

Question 4:

"In addition, if another company acquires a company with accumulated losses carried forward, are these losses transferred at full value to the acquiring company? Would that be possible for losses in all three phases (exploration, development and production)?"

A petroleum company may purchase the shares of another petroleum company, or purchase the petroleum activity as such from another petroleum company.

If a petroleum company purchases *the petroleum activity* with an accumulated loss carried forward, the loss is transferred at full value to the acquiring company, cf. the PTA Section 3 litra c) third Subsection.[33] This applies to all petroleum companies, irrespective of the phase of the production licenses and company's petroleum activity.

If a company purchases the *shares* of another petroleum company with an accumulated loss carried forward, the petroleum activity of the acquired company, including the rules on loss carry forward, remains with the acquired company. In this situation, the two companies will be maintained as two separate entities, and there is no consolidation of the petroleum activities as such. However, if the acquirer is a licensee or already holds shares in a licence, the Ministry of Petroleum and Energy may require consolidation of the petroleum activities in the two companies.

Such direct or indirect transfers of the petroleum activity require the consent of the Ministry of Finance according to the PTA Section 10[34].

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[33] The same applies if the two petroleum companies are merged, cf. the PTA Section 3 litra c) third paragraph. Instead of transferring the accumulated loss, together with the petroleum activity, to the acquiring company, the transferring company may instead choose to claim from the state the tax value of the loss upon termination of its petroleum activity, see the answer to Question 3.

[34] Cf. Section 7 and Section 8 of the Regulations of 1 July 2009 on Consent to Transfers of Production Licenses according to the PTA Section 10.

Question 5:

"The annual cash refund introduced in 2005, applies only for exploration cost of companies in the exploration phase. Companies active in the development or production phase can solely carry forward the losses with interest. Loss carry forward with interest was introduced for all three phases in 2002. In this context, from a selectivity (fiscal) analysis perspective, please provide detailed information as regards the following:

a) Comparison of non-taxable and taxable companies in the exploration phase. Are taxable companies in the same de facto or legal situation as non-taxable companies in the light of the objective pursued by the PTA?"

b) "Comparison between non-taxable companies in the different phases. For example, are non-taxable companies in the development phase in the same de facto or legal situation as non-taxable companies in the exploration phase?"

We refer to section 4 which also provides the Ministry's answer to Questions 5 a and b.

6 Concluding remarks

As described above and in the Ministry's letter of 9 February 2018, the Norwegian PTS has developed over time towards a more neutral tax system. The design of the system, including the rule for reimbursement of the tax value of exploration costs, has been evaluated carefully in order to optimize the value creation and at the same time capture a large part of the extraordinary profit to the benefit of the Norwegian society. When designing the PTS, equal treatment of companies has been an important consideration.

The Ministry holds that the reimbursement rule for exploration costs is not selective, but rather ensures a more equal treatment of petroleum companies. On this basis, the competence to consider the final design of the Norwegian PTS should rest with the Norwegian authorities.

Yours sincerely,

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This document has been signed electronically and it is therefore not signed by hand.

Attachment 1 – consolidation of costs and income

Table 1 illustrates the effect of the consolidated PTS. Here, consolidation means that it is the company's total net income from all production licenses that gives the taxable income. The PTS is however ring fenced against mainland activity.

In the example in table 1, a company has an interest in three licenses on the NCS. The first license has a negative net income of 100 due to costs related to exploration activities. In the second license a discovery is being developed, which results in a negative net income of 150. The third license has a producing field and a net income of 200. With full consolidation of income and losses between licenses, the company's net taxable income is -50. The company can thus claim refunded the tax value of the loss of 50 from the state through the reimbursement for exploration costs. This will be the case as long as the tax loss does not exceed the exploration costs.[35]

Table 1: Effect of consolidation of income and losses between licenses[1]

	Net income
Production license 1 exploration phase	- 100
Production license 2 development phase	- 150
Production license 3 production phase	+ 200
Sum	- 50

[1] As a simplification, this example does not take into account differences in the two elements of the petroleum tax (*i.e.* the special tax that includes an uplift, and the ordinary tax).

As mentioned in section 2.4 in the Ministry's letter of 9 February 2018, one non-neutrality identified in the PTS prior to the 2002 and 2005 changes, was that exploration and investment incentives depended on whether petroleum companies were in a tax paying position or not. At that time, an investment would be more profitable for companies in a tax paying position than for companies recording a loss. This, in turn, gave tax incentives to purchase an interest in producing licenses, with the aim of entering the more favourable tax paying position. Tax-motivated transfers of production licenses that are not based on pure commercial considerations may reduce the value

[35] If the company rather had a tax loss of -100 and exploration costs of 50, the company could only claim reimbursement for 50.

creation from the petroleum activity on the NCS. With equal tax treatment of companies, the incentives for such tax-motivated transfers is reduced.

Table 2 illustrates the unequal incentives prior to the 2002 and 2005 changes. Here, two companies, A and B, each have an interest of 50 pct. in license 1. In addition, company A holds an interest in license 2, which is in the production phase. Company A can consolidate the income and loss from the two licenses, which results in a net taxable income of +100. Company B on the other hand, does not have income from other licenses and is making a net loss of 100. Prior to 2002, the losses for company B would be carried forward *without* interest, and thus lose value over time.

Table 2: Comparison of companies with different portfolios

	Net income company A	*Net income company B*
Production license 1 exploration phase	- 100	- 100
Production license 2 production phase	+ 200	
Sum	+ 100	- 100