Tax Considerations in the Light of Draft Bill on CO2 Transport by Pipelines in Denmark

In the fall of 2023, the Danish government proposed a draft bill on transportation of CO2 by pipelines in Denmark. In this light, I have reflected on some of the tax implications this proposal initially gives rise to. These tax implications are of relevance both in the investment decision as well as the actual assessment of taxable income but is also of significance when policymakers are to ensure favorable framework conditions.

by Katja Dyppel Weber,
Partner, Ph.d.,
CORIT Advisory

Background and Context

In August 2023, a Danish political agreement was reached with the purpose of strengthening the conditions for CO2 capture and storage in Denmark. More specifically, the aim is to address and reduce the barriers that are currently considered to hinder or delay necessary investments in the capture, transport, and storage of CO2 (CCS).

According to the Danish Climate Council, the following four barriers need to be addressed to support the interest in CCS investments until 2030:

- Implementation and realization of the CCS funds that should subsidize the development and promote the CCS technology in Denmark, e.g. by suggesting consolidating the different existing pools
- Ownership and regulation of CO2 transport via pipelines
- Governmental co-ownership of permits for CO2 storage and storage framework
- International framework

In the fall of 2023, Denmark's first main law on transport of CO2 by pipelines was proposed and the draft bill was sent for public hearing. The bill is expected to be presented the Danish Parliament in early 2024.The purpose of the law is to provide a clear framework for future investments in CO2 pipeline infrastructure by establishing clear and uniform rules for pipeline systems transporting CO2.

With the adoption of this law, there will be no distinction between pipelines used to transport CO2 directly for geological storage, directly for Power-to-X (PtX) applications (production of various fuels, chemicals, and plastics, etc.), and pipelines used to transport CO2 for intermediate storage before redistribution for geological storage or use. The law will apply to pipelines in Danish territorial waters, the Danish exclusive economic zone, and the Danish continental shelf area, thus applying to both onshore and offshore pipelines.

Like any other investment, tax implications and predictability of future tax treatment are crucial framework conditions when making long-term infrastructure investments. This includes tax treatment of investment yield, including interests and dividends, timing and rates for depreciations as well expected net cash flow after tax for abandonment costs. However, the tax implications of CO2 transportation by pipeline or storage are not addressed in neither the political agreement nor the draft bill on transportation of CO2 by pipelines.

Governmental Co-Ownership

According to the draft bill, the Danish Ministry of Climate, Energy and Utilities can permit both private and public market actors to own, establish, and operate CO_2 pipeline systems. The permission can be granted with conditions on payment for usage, dimensioning, ownership, alignment, monitoring measures, third-party access, and transport capacity, etc.

Neither the draft bill nor the preparatory work specifies what can be expected by the conditions on ownership. However, nothing indicates that the model of 20% governmental co-ownership through the North Sea Fund, as is the case for CO_2 storage licenses, will also be extended to apply to CO_2 pipeline systems.

If the permission to own, establish, and/or operate CO_2 pipeline systems involves governmental co-ownership through the North Sea Fund or through partnerships with public companies, this may have tax implications, depending on the final legal structure and agreement. Conversely, the involvement of the state in the investment or co-ownership may also be without specific tax implications, for example, if governmental co-ownership constitutes a simple share ownership on the same terms as other shareholders. From a tax perspective, the latter solution is most likely more attractive due to predictability and simplicity, which, however, depends on a concrete assessment including whether the governmental co-ownership is via a taxable or tax-exempt vehicle.

Publicly Available Prices and Terms

To prevent potential abuse of a monopoly-like position by owners of the infrastructure, paid third-party access to the CO_2 pipelines is guaranteed.

Owners of the pipeline systems determine the terms and conditions, including prices/tariffs for CO_2 transport in the pipeline systems but are required to publish tariffs and conditions. It is proposed that the Energy Agency supervises the reasonableness of these tariffs and conditions and is authorized to make justified changes to both tariffs and conditions.

If CO_2 is transported for affiliated companies, it follows from the transfer pricing rules that the arm's length principle should be met, meaning that the transport for tax purposes should be on the same terms and prices as between independent parties in comparable situations. With only few or no adjustments, these publicly available tariffs and conditions, should be able to be used in the transfer pricing analysis and documentation by use of the so -called CUP method (Comparable Uncontrolled Price Method), when determining the intra-group prices. This is because such published prices and conditions, by their nature, constitute prices and conditions set between independent parties. The actual impact of a subsequent change of the tariffs and conditions for CO_2 transport made by the Energy Agency is, however, uncertain and it remains unclear whether such changes will indeed have a material impact.

Bearing the Costs Associated with the Operation of the Energy Agency

It follows from the draft bill, that expenses associated with the operation and handling of cases by the Energy Agency are proposed to be paid by the companies supervised by the Energy Agency. This should be done by following the same principles as for the refund of expenses related to the authorities' case handling of hydrocarbon activities. As such, each liable payer (not limited to a company) will be charged its portion of reimbursed of costs, which is calculated based on recorded hours spent on the performance of each case. It does not seem to be associated with significant uncertainty, whether such reimbursed costs are tax deductible for the liable payers.

Conversion of Existing Oil and Gas Pipelines

It is proposed that the Danish Ministry of Climate, Energy, and Utilities can establish rules on the conversion of existing oil and gas pipelines for the use of transport of CO_2.

Oil and gas pipelines in the North Sea may be subject to the Danish hydrocarbon taxation rules imposing an additional hydrocarbon tax on income from the ring-fenced hydrocarbon activities. Any changed use of such ring-fenced assets can have significant tax effects.

As an example, a conversion can trigger hydrocarbon taxation of recovered depreciations on the pipelines converted to use for CO_2 transport. Further, of potential significant relevance a conversion can affect the possibility of cash-reimbursement of hydrocarbon tax losses (carry-back) of costs related to the abandonment of the pipeline systems. Similar issues arose in connection with the changed use of existing oil and gas platforms in the North Sea to also perform CO_2 storage activities, which led to changes and clarifications of the hydrocarbon tax act for the purpose of ensuring the incentives to invest in CCS storage, by improving and reducing uncertainty about future tax positions.

It follows from the preparatory work, that there currently is a need for further analysis and considerations about the regulation of such conversion, indicating that it is acknowledged that such conversion can trigger a wide range of issues which are currently not addressed. Obviously, policy makers and legislatures are encouraged to ensure, that the tax implications of a possible conversion are also identified and addressed by necessary legal changes for the purpose of providing the right incentives to convert existing infrastructure facilities to CO_2 transport in the future.

Cross-Border Pipeline Infrastructure

Finally, it should be mentioned that it is the ambition of the government that Denmark becomes a European hub for CO_2 storage. Therefore, decisions on ownership and regulation of cross-border pipeline infrastructure have not yet been made. However, it is expected that the government will present a bill in 2024 on the framework for cross-border infrastructure and the interconnection of regional transport networks for transportation of CO_2.

If it becomes possible to own and/or operate pipeline infrastructure across borders, this raises the question of tax presence and income allocation between the relevant countries (on and offshore) where the pipelines are located. In the absence of any other bi- or multilateral agreement on the allocation of taxable income, this will depend on domestic tax rules and existing double tax treaties. From a tax perspective, it is of particular relevance, whether the pipeline constitutes a permanent establishment in the source country, i.e. where the owner is not tax resident, and perhaps more importantly, how the income of such a pipeline-PE should be determined and allocated, and thus what share of the business income the source country has the right to tax.

Given the current state of international law and practice regarding the taxation and allocation of income derived from the transportation of oil, gas, and electricity through pipelines, there is currently not a uniform approach. In numerous countries oil, gas, and electricity pipelines are either wholly or partially governmentally owned and are excluded from foreign ownership, as these pipelines are considered to constitute critical infrastructure. Therefore, in many countries, the question of taxable presences, allocation of income between several countries, and the relevant countries right to tax such income are of less or no relevance. In some countries, specific bilateral agreements on the allocation of the right to tax income from specific pipelines have been concluded in addition to generally applicable double tax treaties.

Where no applicable agreements on the right to tax income from cross-border (pipeline) infrastructure have been concluded, the allocation of the right to tax the income attributable thereto is surrounded by a wide range of unresolved issues, including the assessment of the relevant income. This uncertainty will apply to companies that own and/or operate pipelines transporting CO_2 across the Danish border. Therefore, it is recommended that policymakers and legislators, in their proposal on the framework for cross-border infrastructure, also consider the international tax implications.