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Committee Secretary
Senate Economics Reference Committee
P O Box 6100
Parliament House
CANBERRA ACT 2600

[redacted]

Dear Sir / Madam

Senate Economics References Committee
Corporate Tax Avoidance Inquiry – Taxation of Petroleum Production Activity

We write in response to your email dated 22 February 2017 requesting a submission on the treatment and/or payment of Petroleum Production Royalties, Petroleum Resource Rent Tax, Deductions (assumed to be in relation to the first mentioned taxes), and any other taxes.

We also refer you to our original submission dated 29 July 2015 which includes an overview of the global BP group and BP in Australia for your reference.

Prior to making specific comments, we note this is an important time for the oil and gas sector in Australia. Over the period 2006 – 2015 $276B of investment was made in Australian oil and gas projects[1]. Much of this investment has already occurred. Investments in this "wave" were supported based on, amongst other things, Australia's stable fiscal terms and the understanding these would essentially apply over the life of the projects. The prospect of any material change would therefore cause alarm given the scale of recent investment. Between 2017 and 2025 about $76B of investment is still anticipated[2], absent a material change in the environment including fiscal terms. The challenge BP sees for Australia is how to support the next wave of investment for projects not yet at final investment decision, including encouraging offshore exploration in today's more challenged environment.

This inquiry, therefore, should consider any recommendations for potential changes with caution given the scale of investments recently made and the challenge to bring on the next potentially different "wave" of investment.

[1] Wood Mackenzie Australia upstream summary August 2016 page 29
[2] Wood Mackenzie Australia upstream summary August 2016 page 30

1.0 Overview of Australia's Taxation of Oil and Gas Extractive Industries

The following taxes can be levied in relation to upstream activities. Income tax is the primary tax. Production royalties, excise and PRRT are additional secondary taxes. Broadly, the relationship between these taxes is secondary taxes paid are deductible for income tax purposes. Collectively, upstream companies in Australia can pay government take of >55% over the life on profitable projects which is well above the statutory rate of 30% for other industries. This is because they utilise the community's resources which are not otherwise paid for. However, the timing of tax collected varies between each tax type. The amount of revenue received in dollar terms depends on the market (i.e. oil prices and development/production costs) which can and does change over time.

Production Royalties	This is a State tax and therefore its structure depends on the State involved, in Western Australia it is levied on all hydrocarbon production from State permits or the North West Shelf (NWS) Project. The intention is to tax the wellhead value of production. The structure of tax is agreed with the State Government when production permits are issued.	Rate 10% - 12.5%
Excise	Broadly, this is an additional Federal tax on oil and condensate produced from State permits and the Northwest Shelf Project. The rate applicable depends on the categorisation of the hydrocarbon field.	Rate 20% - 50%
Petroleum Resource Rent Tax	This is a Federal tax levied on profits derived from a project after all costs and a reasonable rate of return has been achieved.	40%
Income Tax	Federal tax levied on taxable income earned in a tax year	30%

We note that there are other taxes to those mentioned in the Inquiry's extended Terms of Reference which include GST, payroll tax, FBT, stamp duty and import duties, as well as the taxes levied on employees and contractors to the industry. Whilst the remainder of this submission focusses primarily on royalties, excises and PRRT, we submit that the total economic value of petroleum resource development is significantly broader than the taxes within the scope of the Senate Inquiry.

1.1 Taxes Paid

Please refer to the detailed summary included in our original submission at Appendix A. BP has a portfolio of Upstream and Downstream businesses in Australia. Upstream production taxes disclosed in the table include both Oil and condensate excise, and wellhead royalty taxes. The Downstream excise and GST are collected from customers and passed onto the ATO. BP, like other downstream players in Australia, has a significant administrative responsibility to collect revenue. But our approach to tax is consistent across all tax types.

2.0 Comments on specific points

The Committee has asked for comment on four points which we respond to below.

2.1 Treatment/ or Payment of Royalties and Excise

The BP Australia group's only producing upstream investment is the North West Shelf (NWS) project. BP is a non-operating joint venture participant and has been an investor in the NWS since before it commenced production in the mid 1980's.

Two production taxes are paid by BP in respect of the NWS. These are Royalties and Excise.

Royalties are charged on all hydrocarbons produced at a rate agreed with the particular State government (10-12.5% is the range of rates generally used in Western Australia, and 12.5% is the specific rate in the case of the NWS) applied to the wellhead value of production. Broadly, to obtain the wellhead value, the sales price is reduced by deductions for costs incurred post-wellhead. However, when those costs exceed revenue and result in a loss, then the deductions are capped to a % of sales and the balance of un-deducted costs are carried forward into later years. The inclusion of a cap on deductions means that taxes are collected even if the investor makes losses.

Excise is payable on Oil and Condensate at various rates depending on the status of the field. Broadly on average NWS fields are taxed between 20% and 30% of the average sale price for production excise once production by field exceeds the exemption threshold.

Both of these systems are very prescriptive and systematic, and there is little scope for varied interpretation of their application. This simplicity is one of their attractions. However, governments, when considering tax policy, ideally want to agree the tax take from a project in advance but this is almost impossible because of the uncertainty associated with development costs and future prices. The risk of a royalty and excise regime is getting the amount of tax right at the start because the taxes are payable from date of production regardless of profitability of the project at that time or in the future[3]. Getting it wrong can lead to impacting investment decisions negatively. In such a circumstance not only is the royalty and excise revenue lost, but so are all the other economic benefits of the development (for example, investment, jobs, demand for services, etc). Please also find herewith a copy of BP's contribution to Australia booklet.

[3] Uncertainty, Risk Aversion and the taxing of Natural Resource Projects'; 1975; Ross Garnaut & Anthony Clunies Ross, The Economic Journal.

The introduction of the PRRT regime in 1987 was to move away from the negative impact that royalty regimes have on investment, accelerate the public economic benefits of development in the form of jobs and other economic opportunities, whilst still obtaining a 40% share of the lifetime profits of the project for the community, albeit deferred until later in project life. This was noted by the then Minister for Resources, who made the following observation at the time:

The Government's decision to fundamentally reform offshore petroleum production taxation has provided a taxation environment that:

- *is economically efficient, i.e. the tax regime will not distort commercial decisions, which should be made in response to market signals;*
- *will provide equitable treatment between the community and resource developers, i.e. will provide the incentive for developers to invest in exploration and development, while ensuring the community a fair return for the exploitation of the community's petroleum resources; and*
- *is administratively efficient and resilient to changes in market circumstances."*

It is important to note the implications of the project lifespan for PRRT: it is not a tax that can be judged by the revenue it generates in a particular short window of the project life. The industry would assert that many of today's new projects are only in existence because the fiscal terms that applied at the time of their final investment decision reduced the risk of loss on downside cases. Even in profitable cases the tax is paid later in the project life therefore impacting the NPV calculation minimally and allowing the acceleration of the other benefits of development.

Conversely, royalties and excise still charge producers the tax even when they make no profit from the activity. A system that increases the amount of loss possible is not sustainable in the longer term. This is because to compensate for the increased potential loss, the internal rate of return required to invest may need to be higher to accommodate the perceived risk[4]. A higher required rate of return for an Australian project puts the investment at risk and potentially makes it less competitive against other projects competing for capital in a global portfolio.

[4] A number of factors are considered in making a positive final investment decision. These may include NPV, IRR, the size of the resource, and alternative investment options available at the time of the decision.

2.2 Treatment/or Payment of PRRT

As you would be aware, the North West Shelf (NWS) began production in the mid 1980s, which was prior to the introduction of the PRRT. It consequently began paying royalties and excise at the prevailing taxation regime at the time, and continues to do so today. At the time the investment was sanctioned, 100% of capacity was sold to Japanese utilities under long term (25 year) supply contracts. These supply contracts removed a degree of uncertainty and risk. A feature of more recent greenfield LNG developments is that not all capacity is sold in advance of the investment decision and capacity which is sold in advance may be for a lesser period. Also, there are far more supply sources available to buyers than when NWS was sanctioned. LNG markets have become more global. For example, Asian buyers now have a choice whether to source LNG within the Asia Pacific region or US West Coast, Africa East Coast or other locations. Uncertainty and risk is therefore greater today for major projects meaning there is more sensitivity to fiscal terms.

NWS transitioned into the PRRT system at the same time as the extension of that regime onshore commencing from 1 July 2012. Despite the extension of the PRRT regime, as noted above, NWS continues to be taxed through the royalties and excise regimes and these payments reduce the PRRT payable so that the project is not taxed twice. Transitional arrangements effectively ensure that, because the historical and ongoing royalty and excise payments exceed the amount that in the absence of that regime would otherwise have been payable as PRRT, there is no additional PRRT payable. BP's expectation is that this will remain the outcome for many years particularly if current oil (and therefore LNG) prices remain for any significant period. Moreover, the Committee might note that the starting base allocated to NWS on its entry into the PRRT regime is only allowed to be used against NWS PRRT assessable income and is not transferrable to any other project. And furthermore, un-deducted PRRT exploration expenditure from other projects cannot be transferred to reduce royalties and excise payable by NWS.

2.3 Interaction with Income Tax

Income tax is levied on annual taxable income at 30%. Annual taxable income is calculated by taking assessable income and deducting allowable expenditures. Deductions in relation to capital outlays on depreciating assets are spread over a period of time. Australian tax depreciation for the gas sector particularly remains internationally and regionally uncompetitive and is a major factor impacting the competitiveness of Australia's income tax (along with the relatively high rate). Certain sections within Australia's Income Tax Act were, however, legislated to allow exploration activity to be immediately deductible for the resource industry. This is because the law recognises the high risk associated with such activity and it also tries to encourage a continuation of those risks being taken for the betterment of the country. Exploration

costs, however, are only a fraction of the total costs for sanctioned projects.

3.0 Conclusions

In broad terms, a profitable upstream project should expect to pay >55% of their profits as tax over the life of the project. This is significantly more than the tax rate on other business activities in the Australian economy and is a reflection of the fact that an oil and gas resource is a sovereign non-renewable asset of the community not otherwise paid for.

The deferral of a reasonable proportion of the total tax take to after the project's breakeven point is reached is an essential pre-condition for Australian projects: i.e. to reconcile both the need for the higher take with the need to incentivise investment compared to other countries that can access reserves for less cost and are closer to markets.

BP respectfully submits to the Committee that:

a. The benefits to the Australian community from oil and gas development are broad, and include the creation of jobs and the procurement of goods and services as well as taxation. Furthermore the taxation benefits of oil and gas developments are broader than simply the PRRT and specific petroleum production taxes, and include income taxes, PAYG, payroll taxes and so on.

b. Royalties and excise have a certain simplicity and they recover steady cash flows across the life of the project. However, their regressive nature can deter investment and reduce the total return to the community.

c. The PRRT collects revenue later in a project's life, but by doing so it creates the conditions for incentivising investment. It maximises the total long term economic return to the community. This advantage of PRRT may become more important, not less, for traditional greenfield LNG development concepts given the expectations of a prolonged period of relatively low oil and gas prices and higher relative development costs in Australia compared to other countries which can access resources more cheaply and are closer to markets.

We trust this submission addresses the Committee's areas of interest. If you have any questions on any of the above, please do not hesitate to contact me direct, or contact [redacted]

Yours faithfully
BP Developments Australia Pty Ltd

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