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REMOVAL OF ONSHORE PETROLEUM PROJECTS FROM PRRT

Dear Committee Members

Thank you for the opportunity of making a submission on legislation to amend the Petroleum Resource Rent Tax regime. The extension of time granted to make this submission is also appreciated.

Reason for Submission

Santos Ltd has sought an independent assessment of the proposed removal of onshore oil and gas exploration and extraction activities from coverage by the provisions of the Petroleum Resource Rent Tax (PRRT) as from 1 July 2019.

I was approached to make this independent analysis because of my experience and expertise in the economics of royalty and taxation regimes designed to apply to projects and enterprises in the mining and petroleum sectors. This knowledge has been built up since the late 1970s. It has included negotiation and formulation of the Barrow Island Resource Rent Royalty arrangement involving oil producers, the Western Australian Government and the Commonwealth Government in the mid-1980s prior to implementation of the PRRT. It also has included a major review of offshore petroleum exploration policy for the Commonwealth Government in 2012.

Background

The Government signalled its intention to remove onshore oil and gas projects from coverage by the PRRT in its response to the *Petroleum Resource Rent Tax Review: Final Report*, which was written by a team led by Mike Callaghan. This major change to the PRRT's coverage was not recommended by the review team. However, the proponents of the change have sought to justify it by reference to the review team's criticisms of aspects of the application of the PRRT to onshore exploration and extraction activities.

The proposed amendments to the *Petroleum Resource Rent Tax Assessment Act 1987* are set out in the *Treasury Laws Amendment (2019 Petroleum Resource Rent Tax Reforms No. 1) Bill 2019* and explained in an Explanatory Memorandum circulated by the authority of the Treasurer. The Explanatory Memorandum has drawn upon points made in *Petroleum Resource Rent Tax Review: Final Report*.

The rationale offered by the Government for removing onshore oil and gas projects from coverage by the PRRT is that it protects revenue and simplifies administration of the tax regime. It was argued that onshore projects were unlikely to pay PRRT, but owners could transfer exploration expenditures to their offshore projects with positive cumulative cash flows after uplifts, thereby reducing government revenue from offshore projects. The observation that onshore projects were unlikely to pay PRRT was linked to a provision in the amended Act that allowed inclusion of the

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market value of assets including the value of the resources *in situ* as at 2 May 2010 (when oil and LNG prices were relatively high) in the deductible cost base. This provision effectively cancelled out the tax base that already existed at that time.

Focus of Submission

The main focus of this submission is the unintended adverse consequences of removal of onshore oil and gas projects from coverage by the PRRT, without transition arrangements to mitigate undesirable effects. These unintended adverse effects have been reviewed in this letter. In addition, a transition arrangement to help mitigate some adverse consequences has been discussed herein.

Policy Objectives/Criteria

The implementation of the PRRT in the mid-1980s was linked to two policy objectives:

- improvement of the efficiency of allocation of resources
- improvement of the distribution of benefits of extraction of extractable resources in favour of the community that owns them.

These objectives could be restated as:

- increasing the amount of realisable resource rent (nett value of resources) as much as possible or avoiding inadvertent destruction of it
- capturing a reasonable share of resource rent for the community.

It appears that the same objectives underpinned the extension of the PRRT to onshore oil and gas exploration and extraction activities. This is obvious from three aspects of the regime.

First, crediting state royalties against PRRT liabilities effectively neutralised the adverse effects of state royalty regimes on the realisable amount of resource rent and on the efficiency of resource allocation. It has been suggested that this effect was dependent on PRRT being payable by owners of onshore oil and gas projects. However, that is misleading, because transferability of exploration expenditures would provide an offset to the tendency of state/territory regimes to discourage marginal exploration.

Second, transferability of exploration expenditures after 1 July 2012 to PRRT-paying projects reduced the likelihood of deductions being denied for such expenditures that related to unsuccessful ventures. Therefore, this mechanism moved the PRRT regime closer to one that treated gains and losses symmetrically or even-handedly (a full loss offsets regime) as an economically efficient tax should, and therefore reduced discouragement of exploration.

Third, while the extended PRRT regime removed the value of resources *in situ* as at 2 May 2010 from the tax base, it brought additions to resources generated by subsequent exploration and other assessment into the tax base. Appropriately, those expenditures became deductible expenses. To ensure even-handed or symmetric treatment of potential future revenues from additional resources and the exploration expenditures that led to confirmation of those resources, transferability of such expenditures was allowed from 1 July 2012.

A highly controversial aspect of the PRRT extension that received considerable attention in 2012 was the allowance of inclusion of the value of the resources *in situ* as at 2 May 2010 (when oil and LNG prices were relatively high) in the deductible cost base. Because this provision effectively cancelled out the tax base that already existed at that time, some perceived it to be a violation of the objective of capturing a reasonable share of resource rent for the community. A less prominent criticism was that it undermined the neutralising effect of the PRRT on adverse effects of state/territory royalties on the efficiency of resource allocation, although this was relevant to existing projects, not new ventures. On the other hand, others perceived that cancelling out the tax base that existed as at 2 May 2010 was appropriate as a transition arrangement to avoid discouragement of exploration and investment (resource misallocation) as a result of creation of a sovereign-risk or time-inconsistency problem through changing the rules of the game after commitment of capital to exploration.

The objectives that framed previous formulation of PRRT policy and discussion of it are implicit in the *National Resources Statement* issued by the Minister for Resources and Northern Australia in

February 2019. They should be used as criteria in assessing the proposed changes. The widespread use of these objectives in assessing policy changes in Australia, such as in mandatory regulation impact statements/assessments, and consistency in application of them as criteria in changes of PRRT policy from time to time support the view that they should be applied again.

Assessment of Removal of Onshore Petroleum from Coverage by PRRT

The rationale for removal of onshore petroleum exploration and extraction activity from coverage by the PRRT ignored the important objective of improving the efficiency of resource allocation that has influenced previous PRRT policy. Instead, the rationale focussed on revenue and the associated issue of resource rent redistribution in favour of the community. It overlooked the important point that adversely affecting incentives tends to reduce the realisable resource rent in the medium to long term. This has implications for the absolute amounts that can be distributed to the community and to entities engaged in exploration and extraction activities.

Removal of onshore oil and gas from the purview of the PRRT would eliminate even-handed treatment of gains and losses in the onshore oil and gas exploration and extraction sector. Then, the state/territory royalty regimes will influence decisions regarding post-2019 activities, rather than the PRRT regime. Those royalty regimes perform poorly in terms of the criterion of improving the efficiency of resource reallocation, as they ignore exploration and extraction costs, being linked to gross revenue. They also perform poorly in terms of the distributional criterion. The design of the state/territory royalty systems is such that they could not capture significantly more resource rent for the community without causing considerable damage to incentives to explore and invest and associated resource misallocation.

The introduction of the PRRT in the mid-1980s and its subsequent extensions to Bass Strait, the North West Shelf, and onshore areas were designed to avoid sovereign-risk or time-inconsistency problems and associated adverse effects on incentives and the efficiency of resource allocation. The proposal to remove onshore petroleum from the purview of the PRRT does not include any arrangements to avoid such problems. In particular, there is no transition arrangement to allow for the considerable onshore petroleum exploration expenditure that has been undertaken since 2012 under a PRRT regime that provided even-handed treatment of gains and losses from exploration activity by allowing transfers of exploration expenditure to onshore and offshore projects with positive cumulative cash flows after uplifts. That exploration expenditure will be ignored under state/territory royalty regimes.

A transition arrangement is required to avoid creation of a sovereign-risk problem that could reduce future exploration and extraction activity. One such arrangement would be a five-year transition period to allow entities to transfer undeducted onshore exploration expenditure incurred after 1 July 2012 to offshore projects for which PRRT is payable. The ability to make such transfers would expire on 30 June 2024.

Such a scheme would be a reasonable mechanism for mitigating the resource misallocation problems arising from creation of sovereign risk. However, it is not the only acceptable scheme that could be applied to avoid time-inconsistency problems.

There could also be fairness issues requiring consideration. In particular, the proposal to remove onshore oil and gas from the purview of the PRRT could discriminate against entities with heavy involvement in onshore and offshore exploration and extraction activities, and with post-2019 timing of anticipated positive cumulative uplifted cash flows from offshore petroleum production.

It is also noteworthy that such discriminatory policy could exacerbate sovereign risk issues. The transition arrangement outlined above would address the discrimination issue, as well as resulting sovereign risk problems.

Further Information

I would be happy to elaborate on the points made above if you would like more detailed explanations of any of them. Similarly, I could address other issues if you would like my views on them.

In addition, I would be available to appear before the Committee if required. It is assumed that you could offer some flexibility in relation to appearance times that would facilitate a trip to Canberra.

Yours sincerely

KEN WILLETT
PRINCIPAL

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