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Mr Peter Hallahan
Committee Secretary
Senate Economics Committee
Department of the Senate
Parliament House
Canberra ACT 2600

Dear Mr Hallahan

Provisions of *Tax Laws Amendment (2004 Measures No.7) Bill 2004* : Submission by the Australian Petroleum Production & Exploration Association Limited

The Australian Petroleum Production and Exploration Association (APPEA) is the national body that represents companies engaged in oil and gas exploration and production operations in Australia. APPEA welcomes the opportunity to provide the Senate Economics Committee with this submission that deals with certain provisions contained in Tax Laws Amendment (2004 Measures No.7) Bill 2004 (hereafter referred to as 'the Bill'). Specifically, APPEA's comments relate to the following aspect of the announced terms of reference:

> *"Schedule 5 of the bill is intended to provide a tax incentive for petroleum exploration in 'designated frontier areas'. Exploration expenditure, within certain limitations, will be uplifted to 150 per cent, with this amount being deductible for the purposes of petroleum resource rent tax. One issue identified for investigation is the cost and effectiveness of the proposed tax concessions in encouraging petroleum exploration in remote offshore areas."*

Industry Background

In 2001, CoAG recognized that the energy sector affects the lives of all Australians and that it underpins responsible and sustainable development, international competitiveness and economic growth. As such, a reliable and competitively priced supply of petroleum is essential to the Australian economy and to meeting community needs and maintaining our lifestyle.

Petroleum (oil and gas) is the energy source for over 70 per cent of Australia's final energy consumption, while liquid petroleum supplies nearly all our transport energy needs. Forecasters predict a continuing reliance on petroleum for the foreseeable future.

The industry makes a significant contribution to Australia's economic growth and well-being. For example:

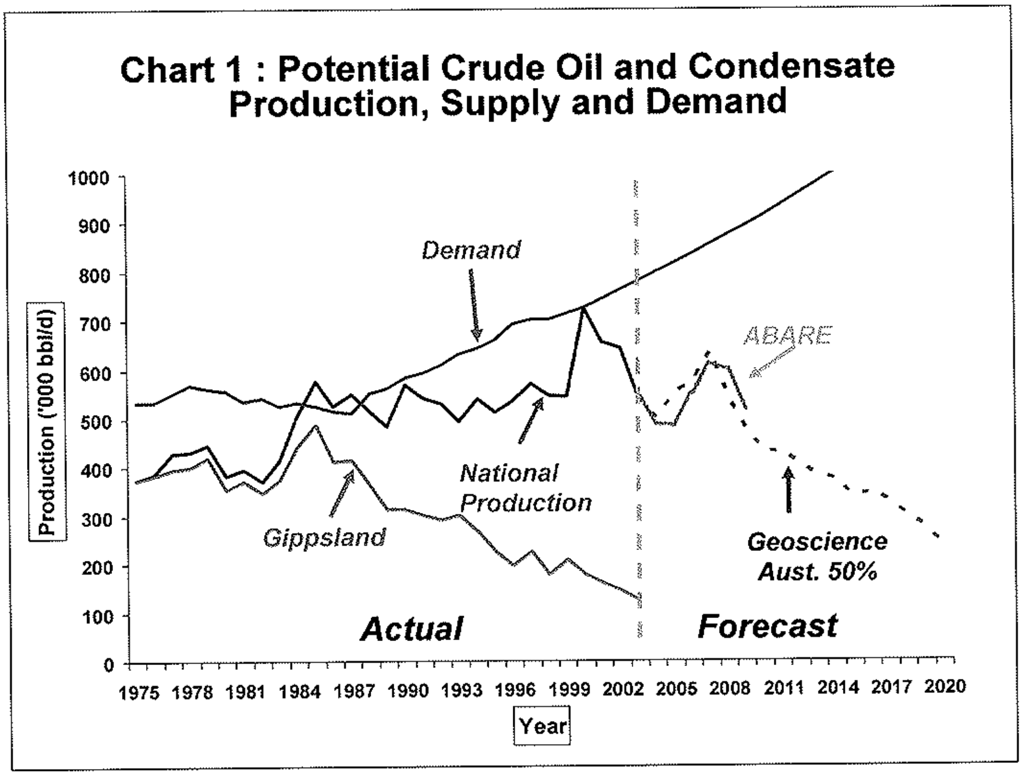
- in 2003/04, Australia generated export income of nearly $9.5 billion dollars from the sale of crude oil and petroleum related products (including liquefied natural gas) compared with imports of $10.2 billion. Domestic production importantly allows Australia to replace costly imports of petroleum;

- the industry is a major contributor to government revenues through direct taxation payments. In 2003/04, the industry paid more than $2.5 billion in resource taxes alone – the vast majority of this amount is paid to the Federal Government (petroleum resource rent tax payments of $1.56 billion are forecast for the year 2004/05). In addition, APPEA estimates that company tax payments from the industry in the same period were well in excess of $1.5 billion;
- macroeconomic modelling conducted by the Australian Bureau of Agricultural and Resource Economics indicates that a 20 per cent rise in the Australia's oil and gas output leads to increased economy wide output of between 0.3 and 0.5 per cent; and
- the industry employs (both directly and indirectly) tens of thousands of workers in urban and regional Australia.

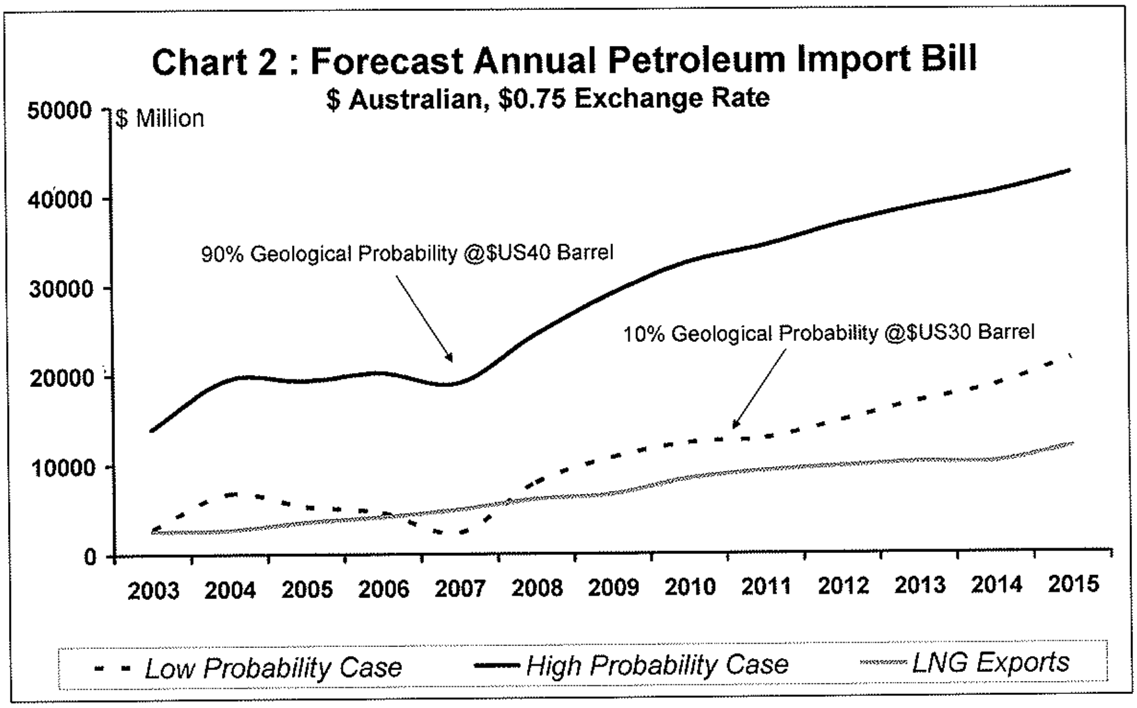
The petroleum industry also delivers significant social and environmental benefits. Petroleum is critical to delivering an energy supply that is reliable, competitively priced and sustainably produced.

<u>Trends in Future Oil and Gas Production</u>

Petroleum Liquids



Geoscience Australia estimates Australia's remaining commercial reserves of crude oil to be 819 million barrels (mmbbl) and of condensate to be 671 mmbbl (as at 1 January 2003), which is equivalent to about 5 years current consumption. Estimates of reserves that have not yet been declared commercially viable are 716 mmbbl and 1754 mmbbl respectively. While reserves of condensate are significant, their potential rate of production depends largely on the commercialisation of the associated gas resource. As indicated in Chart 1, production of crude oil and condensate is about to decline rapidly. Unless there are significant new discoveries, Australia will be importing 50% of its requirements by the year 2010. The lower production and resulting import bill will naturally have a considerable impact on the balance of payments (see Chart 2), on reduced tax collections and on the costs of holding stocks of petroleum.



Gas

Natural gas production has increased substantially over the last four decades and ABARE forecasts a considerable expansion of gas demand in Australia in the years to 2020. While total gas resources potentially exceed the amount of gas required in the next 20 years, APPEA does not believe that it is always valid to assume that supply will simply expand to meet demand. This will particularly be the case if prices fall in real terms.

Exploration for, and subsequent commercialisation of gas is critical to meeting the aspirations of government and the community. The gas industry is facing some potential constraints in the future given current projected supply commitments. Additional sources will be required into the north of Australia in the next few years and for Eastern Australia within 10 years. For Australia to reach its target of 30% of the Asian LNG Market by 2030, additional projects above those already identified will need to be commercialised.

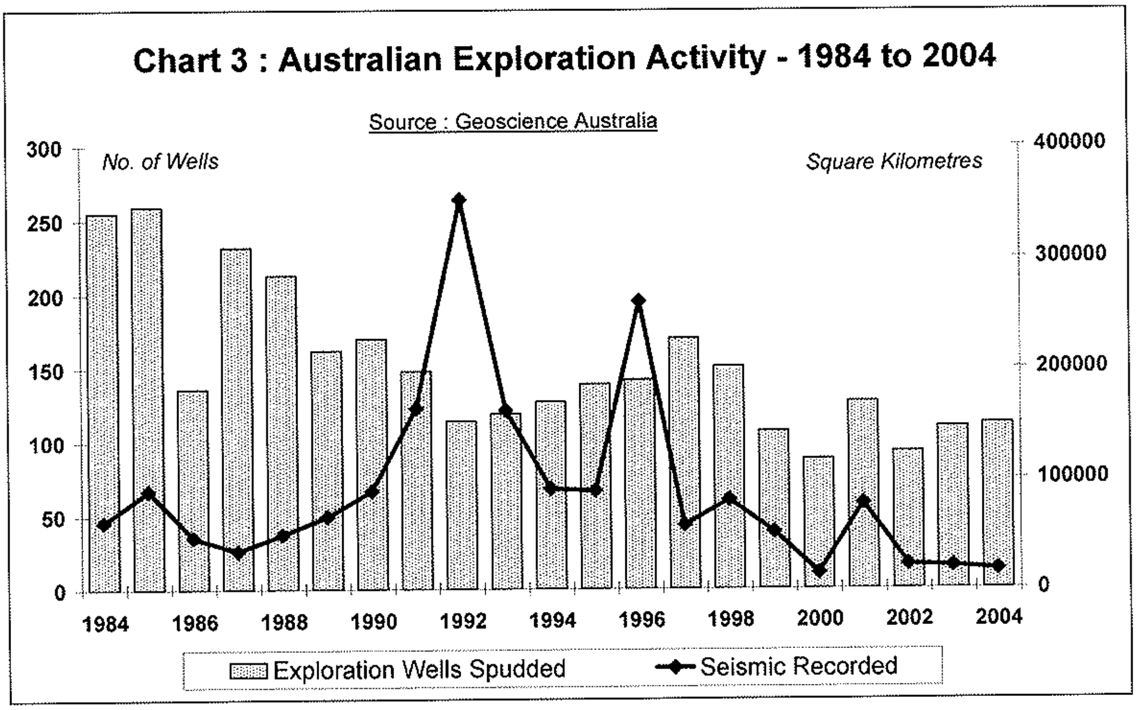
Not all reserves are commercial and therefore may not be producible. If only reserves classified by Geoscience Australia as commercial are taken into account, it is possible that additional quantities of gas will need to be commercialised if projected demand is to be met. In a geographic context, much of Australia's vast gas resources are remote from centres of population and gas markets. The long distances involved in transporting some of this gas to markets have a significant impact on the economics of gas developments.

The growth in sales of liquefied natural gas (LNG) has the potential to provide an important source of export income for Australia. Nevertheless, the contribution that such sales can make relative to the overall expansion in imports that will arise to meet our liquid fuels needs is clear in Chart 2 - it is relatively small in comparative terms.

International Petroleum Analysts, Wood Mackenzie Limited, recently noted that "..as of 2003 the majority of offshore production has been liquids and yet nearly three times the equivalent volume of gas has been technically discovered, but is considered non-commercial now (not onstream within five years)."

Exploration Trends

As measured by the number of exploration wells drilled, petroleum exploration and development in Australia has generally declined over the last two decades, although there has been a slight pick up since the low of 2000 (see Chart 3). While the recent marginal improvement in exploration levels overall is encouraging, APPEA believes it is less than adequate in the face of the imminent decline in liquid fuels self sufficiency. In addition, the amount of seismic kilometres that has been shot has fallen dramatically from the peak levels of the early 1990's – again, this will have long term negative consequences.



Drilling success rate associated with activities in Australia (particularly offshore) are generally regarded as being poor in relative terms compared with other countries. To assist in reversing this decline, policy needs to respond to the view that prospectivity of Australia for both oil and gas is not as attractive as that in many other parts of the world and that Australia is a high cost and relatively high technical risk investment destination.

The Need For Fiscal Enhancements

As indicated above, the fiscal framework that confronts investors in Australia's petroleum exploration and production industry fundamentally impacts on investment decisions. The potential challenges confronting the industry were highlighted by Wood Mackenzie in 2004 when they stated that:

> *"..offshore Australia is glimpsing over a horizon that is potentially bad, and may yet turn ugly on two fronts - firstly, that as an oil exploration province the characteristics are those of a mature region where average discovery sizes are decreasing and production growth, at least in the short to medium-term appears to be in a steady decline. Secondly, the merging good news on commercialisation of stranded gas resources may yet turn sour, particularly if Australia's LNG is not commercially competitive on the international stage to win foundation customers for greenfield developments. This outcome would potentially defer gas developments that may not be able to capture sufficient domestic demand for startup."*

Coupled with the above is that over the last decade, less than 7 per cent of exploration wells drilled in Australia have made commercial discoveries. Today's exploration underpins tomorrow's oil and gas production.

Frontier Exploration Incentive

Proposed Incentive - Background

As part of the recently completed House of Representatives Standing Committee on Industry and Resources inquiry into exploration impediments in Australia, APPEA sought the introduction of a bonus or premium for exploration in Government designated high risk and frontier acreage to address the higher risks in undertaking exploration in these areas. APPEA suggested the introduction of an uplift under the company tax system for exploration expenditures incurred in nominated areas, a key rationale being that such activity is akin to high risk research and development.

As part of the 2004/05 Federal Budget, the government announced the proposed introduction of a 150% uplift under the PRRT regime for a limited number of permits in largely deep water and/or frontier areas. As part of the announcement, it was stated that:

- the incentive is designed to encourage petroleum exploration in Australia's remote, high cost and high risk offshore areas;
- the uplift applies to 'pre-appraisal' exploration expenditure in the initial term of the exploration permit and the existing transferability rules will be maintained; and
- up to a maximum of 20 per cent of each year's acreage release areas can be designated (six blocks were nominated in the current round) with a range of criteria to be applied in determining the final acreage.

Estimated Cost to Revenue

It is estimated that the initiative will have a total cost to revenue of $17 million over the four year period 2004-05 to 2007-08. APPEA considers that this is likely to represent the upper range of the cost over the period due to a combination of factors. Specifically:

- the potential lags between the initial bidding process and the completion of the initial term of the exploration permit (the period over which the incentive applies) can be in excess of six years;
- the financial impact of the provision will to a large extent be determined by the types of entities that are successful in being awarded the relevant acreage. Entities that have an existing PRRT paying project elsewhere will generally be entitled to immediately offset the deduction through the wider deductibility provisions. Conversely, those entities that do not have an existing PRRT project will face a somewhat differing deduction profile, and through the application of the various carry forward rules, may either achieve a higher or lower benefit;
- as PRRT payments are deductible for corporate tax purposes, an entity that is entitled to a lower PRRT liability via the application of the incentive will see an increase in their company tax payments;
- the expenditure and information obtained from such exploration activity may also allow Geoscience Australia to redirect their resources to other offshore areas; and
- the extent to which the designated frontier acreage is successful in obtaining bids will also ultimately determine the level of cost to revenue.

APPEA Position

APPEA considers that it is essential for the taxation framework to recognise that exploration in some areas is inherently riskier (both technically and financially) than in other areas. In responding to these differences, there are a number of approaches which can be considered to potentially stimulate the activity in riskier areas. APPEA supports the PRRT initiative as an important recognition that the tax system must be tailored to meet these differences, and within its specific terms of reference, we consider that it will act in a way to encourage exploration in the nominated areas.

Another direct benefit that will arise from the take-up of the new acreage is that over time, it will provide the government with new and additional information on the geological and technical profiles of relatively unexplored areas. From a strategic perspective, this will allow for the targeted release of future exploration acreage via the work program bidding process.

The success of the provision will largely be dictated by the acreage that is nominated as frontier in nature and therefore eligible for the incentive. Ultimately, entities will only bid for acreage that they consider to be prospective. In this context, APPEA recommends that it would be useful if the relevant government agencies (including Geoscience Australia) were to provide guidance on the technical factors that they propose to consider in the determining the annual nominated frontier acreage (including consultation processes with industry).

As bidding for the first round of nominated acreage closes on 31 March 2005, and recognising that prospective bidders will require as much time as possible to prepare detailed bids in full recognition of the fiscal framework, it is recommended that the Senate supports the proposed Bill.

APPEA would be pleased to further expand on any of the recommendation or comments contained in this submission. Contact in the APPEA Secretariat is Noel Mullen, tel 02 62670904 or email nmullen@appea.com.au. APPEA would also be pleased to appear before the Committee and further expand on the comments outlined above and to address any additional questions.

Yours sincerely

Barry Jones
Executive Director