



SUBMISSION

Submission to the Review of the Petroleum Resource Rent Tax

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The Business Council of Australia is a forum for the chief executives of Australia's largest companies to promote economic and social progress in the national interest.

Executive summary

Introduction

The Business Council of Australia welcomes the opportunity to provide a submission to the Review of the Petroleum Resource Rent Tax (PRRT). This review is an opportunity for a considered and evidence-based debate on the operation of oil and gas taxes and royalties, such as the PRRT.

The Business Council believes companies must meet their tax obligations and do so in a transparent way – including the PRRT. We understand the government's call to ensure protection of Australia's revenue base and confirm that companies are paying the right amount of tax.

The Business Council believes the PRRT has worked appropriately to date. No changes should be pursued without a clear, demonstrable net benefit from doing so. The tax system, indeed the broader investment climate, must ensure that the Australian economy, which is heavily reliant on trade and foreign investment, remains strong, builds investor confidence and continues to grow. This is especially important as we look for the next wave of industry exploration, investment and growth. Exploration is currently at a low ebb, but there are many opportunities that can be unlocked. The tax system will play a vital role in providing the environment for developing the projects of the future.

Concerns about current PRRT revenue levels are misplaced. The tax is operating as intended and designed, with current revenues reflecting the current unique stage of the industry's cycle. After completing almost a decade of large-scale investments, in a high-cost environment, the oil price has fallen sharply. Taxes, including company tax, will be paid in future when production and profits flow from those investments. A delay in recouping PRRT revenues is a core feature of the design of a profits-based tax, an approach that was deliberately chosen 30 years ago and continues to be appropriate.

The case for change has not been made. Changing the basis for the tax, in particular where this would impact current projects where investment decisions have already been made, would risk unintended consequences such as reducing competitiveness, damaging investor confidence (not just in the oil and gas industry) and deterring vital investment.

It will be crucial, as per the terms of reference, not to be 'discouraging investment in exploration and development'. Of course, the tax system must also ensure the community receives an appropriate return for its resources. But we must not lose sight of the fact that appropriately compensating the owners also means not compromising efficiency by discouraging investment.

Australia has to remain competitive when the capital for resources investments is highly mobile across different countries and industries. This simply results in a smaller pie for everyone. Investment depends heavily on a stable and competitive tax regime, as well as appropriate broader policy settings.

1. Setting the scene

The petroleum sector is experiencing a unique phase of the cycle

The oil and gas sector is coming off an enormous investment boom. The value of mega oil and gas projects underway went from \$10 billion in late 2007, to \$200 billion in five years. Most of these projects have finished construction, but over \$100 billion worth of projects are set to finish in 2017.¹

Resources prices have fluctuated wildly over the past decade, which holds true whether comparing real or nominal prices. For example, the spot crude oil price ranged between \$US30 per barrel to \$US134 per barrel over the past decade. The recent collapse followed a few years of a price around \$US100 per barrel, before more than halving in the space of just a few months. The outlook for oil and gas prices remains subdued.²

Figure 1: Spot crude oil price, West Texas Intermediate



Source: Federal Reserve Bank of St. Louis.

Petroleum projects should be considered over their lifetimes

The \$200 billion worth of investment in petroleum projects will continue to deliver a wide range of community benefits through jobs, taxes, contracts with local suppliers and investment in universities and research institutes (including impact assessment studies, monitoring programs, environmental baseline studies, and peer review research papers). These projects operate on long cycles that can extend for many decades, from exploration through to development, production and decommissioning.

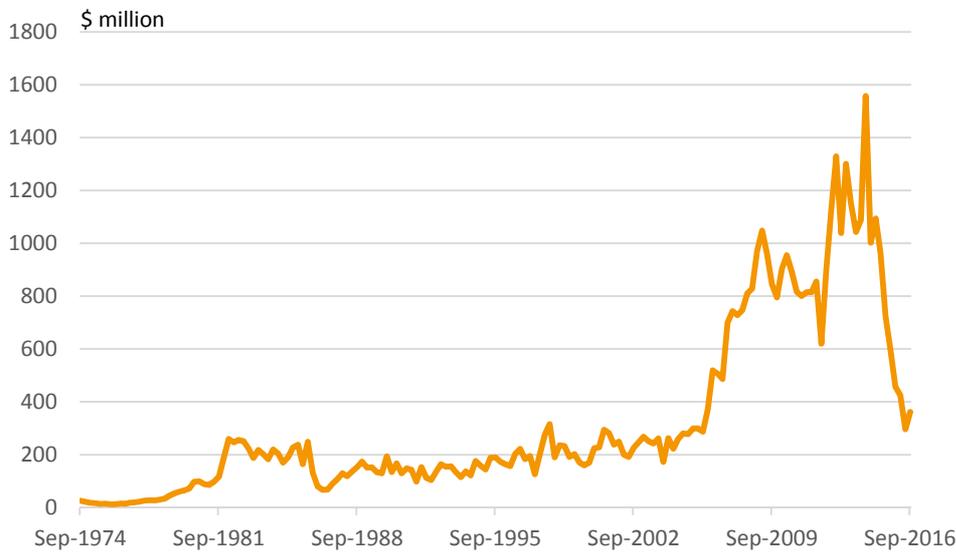
As the price of oil has collapsed, so too has petroleum investment and expenditure in Australia. Deloitte Access Economics' Investment Monitor has not recorded any new LNG developments in its database for almost two years and describes the outlook for oil sector

¹ Deloitte Access Economics Investment Monitor December 2016.

² World Economic Outlook Update January 2017.

investment as 'bleak'.³ New exploration and investment will be critical to unlocking the next wave of investments, jobs and growth. This will only occur if Australia is an attractive place to invest.

Figure 2: Petroleum expenditure in Australia has collapsed



Source: ABS cat. no. 8412.0.

What is the life cycle of a project?

Major resource projects can have very long lead times from when a resource is discovered, to further evaluation, project design, government approvals and development before finally beginning production. The task is highly complex and risky, and many projects may not make it past the exploration stage.

The long life cycle of a project

The fields that provided the basis for the North West Shelf project were discovered through exploration between 1967 and 1972. Further discoveries were made and the project received approval in 1979. First gas was received in 1984. Since then the project has expanded as additional discoveries were made, technology and viability changed and the project began exports.

In its totality, this is a 50-year project – so far.

Table 1 below outlines the life cycle of a petroleum project. It highlights the risks and uncertainty along the way, including the extensive lead times. The profile of revenue, expenditure and profits of a project magnify these risks.

³ Deloitte Access Economics Investment Monitor December 2016.

Table 1: Life cycle of a petroleum project (indicative)

| Stage | What is involved? | Length | Profits/expenditure |
|----------------------|--|------------------------------|--|
| Acquire the permit | Acquiring the rights to exploration for a certain area. | Less than 1 year | No profits |
| Explore and evaluate | Explore and evaluate the area to determine if it contains a commercially viable resource. This may include detailed site surveys, exploration drilling and appraisal drilling. | 7–15 years, possibly longer | No profits but operating and capital expenditure |
| Develop the resource | Seek development approval. Undertake large and complex task of building the facilities to enable production. | 1–8 years, possibly longer | No profits but large capital expenditure and operating expenditure |
| Production | Begin to extract the resource once development is complete. Production profile may differ across resources and projects. | 10–30 years, possibly longer | Profits as expenditure is recouped, also ongoing operating and capital expenditure and taxes |
| Decommission | When the resource is exhausted or no longer viable, the project will be shut down. Infrastructure will be removed in an environmentally responsible way. | 1–2 years, possibly longer | No profits but decommissioning expenditure |

Different projects present different issues

The diversity in petroleum projects across Australia makes it difficult to make comparisons between projects and understand how profits and taxes intersect. The sector has also changed over the past few decades. For example, the oil sector was much larger than LNG when the PRRT was introduced. This context is critical to understanding both project outcomes and implications for tax.

- The length and nature of risks at each stage of the project life cycle may differ. For example, development of an oil platform can take place in as little as 18 months, while an LNG plant can take up to eight years to construct prior to the commencement of production.
- The payback periods for oil versus LNG projects can differ greatly, such as due to different production profiles.
- Differences around taxing points.
- Older projects were developed at a different time with different constraints. For example, the recent construction phase has faced cost challenges and complexities due to simultaneous demands being placed on limited resources in Australia.

These factors highlight that context is important when considering these projects, as well as when and how much tax is paid. The years of upfront heavy investment need to be recouped before tax is paid. The rate at which such recoupment occurs may vary, such as between oil projects and gas projects, but this is a design feature of the PRRT, not a flaw, to ensure that socially productive capital investment is not discouraged. We strongly reject any contention that the PRRT, as designed, is not suitable for LNG projects. The timing of

this recoupment will also depend on factors such as commodity prices, exchange rates and project costs.

Why is the development of major projects in Australia expensive?

The Business Council previously observed the high cost of investing in Australia and low labour productivity compared with other nations, leading to reduced competitiveness of project delivery.⁴ Through research it has been found that resources projects are 40 per cent more expensive to deliver in Australia than in the United States Gulf Coast. Productivity on Australian projects was estimated to be 30 to 35 per cent lower than for comparable projects in the US.

The US is a commonly used comparator due to its market size and the depth of project management and delivery capabilities. It provides a useful indicator of relative performance to Australia, particularly as a comparator of large oil and gas projects.

Table 2: Summary of Australian project cost performance (without location adjustment)

| Project type | Average cost compared with US Gulf Coast |
|-----------------------------------|--|
| Sustaining capital projects | 40 per cent higher |
| Large complex processing projects | 50 per cent higher |
| Offshore oil and gas developments | 200 per cent higher (offshore platform and pipeline components only) |

Source: Internal report for the Business Council of Australia by Independent Project Analysis, 2012. **Note:** The Independent Project Analysis database consists of 713 Australian projects primarily in the oil, gas and mining industries and over 16,000 projects worldwide. The projects range from less than \$1 million to over \$10 billion.

The US Gulf Coast compares favourably given its deeper pool of skilled labour, a mature industry and regulatory system, and a generally lower cost of living. This provides a more favourable set of conditions for delivering capital projects, and could be difficult for Australia to emulate in the short term.

The resources investment boom also presented issues unique to Australia, with the nine largest projects delivered in Australia's history simultaneously either underway or about to commence. Intense competition for resources arose, given not all projects can employ the same limited group of personnel skilled in project design, management and delivery. Similarly, not all projects can buy from the same market for intermediate goods and equipment. This can lead to delays or cost overruns.

Other drivers of high costs include the efficiency of government processes for planning, project approvals and conditions, quality of project design and management, workplace productivity and relations, and the development of projects in remote areas. While Australia benefits from a regulatory system that safeguards environmental, safety and cultural standards, other countries may be less strict. There may also be multiple, inefficient processes across and between governments that are ill-equipped to deal with

⁴ See *Pipeline or Pipe Dream: Securing Australia's Investment Future*; and *Report of the BCA Project Costs Task Force*.

multiple cross-jurisdictional major projects. This can significantly add to project costs and delay commencement.

The experience of one Business Council member company seeking approval for a major project is an illustrative example of the complexities of the government approvals process.

The environmental assessment done under federal and state legislation took more than two years, involved over 4000 meetings, briefings and presentations across interest groups and resulted in a 12,000-page report. When approved, more than 1500 conditions (1200 state and 300 federal) were imposed. These conditions had a further 8000 sub-conditions and the company invested more than \$25 million in the environmental impact assessment alone.

In addition, operating in remote environments presents many challenges. For example, cyclones and severe weather events can disrupt activity, while the hot climate can reduce labour productivity. In addition, the relatively large distances covered in transit between accommodation, break areas and work sites reduces 'time on tools'. There can also be a snowballing effect where small delays, uncertainties or risks taken in the pre-construction phase can result in major cost escalation during construction, particularly as the project becomes larger and more complex.

At the time of the Business Council analysis, engineers charged rates from \$160 to \$220 dollars per hour on major projects like Gorgon, Ichthys and Wheatstone. Engineering rates for mega projects were around 30 to 50 per cent higher than the standard rates in Houston for US Gulf Coast projects.

2. Petroleum Resource Rent Tax

What is the PRRT?

The Petroleum Resource Rent Tax (PRRT) is one of the means through which the Australian community, as owners of the rights to non-renewable resources, receives a return for the extraction of these resources. Other charges can include crude oil excise, Commonwealth petroleum royalties, and state and territory petroleum royalties.

How does PRRT work?

PRRT is levied on the taxable profits of petroleum projects at a rate of 40 per cent. It is calculated as assessable receipts, such as the sale of oil and gas products, minus deductible expenditure, such as project exploration, development and operating costs.

Unused losses are carried forward to be used as a deduction in future years. Critically, the value of these losses is uplifted annually by a modest rate. This uplift rate attempts to preserve the real value of the project's PRRT losses, and compensate investors for the risk of the activity. In effect this means that tax is not paid until a project makes a threshold rate of return.

PRRT is payable when the assessable receipts minus all deductible expenditure is positive. These profits are also subject to corporate income tax, which can lead to an effective tax rate of 58 per cent.

Other resource tax payments are creditable against PRRT to avoid double taxation.

How does PRRT differ from company tax?

Company tax and PRRT differ greatly. All PRRT expenses are immediately expensed, in contrast to company tax where investments are typically depreciated over the life of an asset. Like company tax, unused losses are carried forward but with a key difference that PRRT losses are uplifted at a legislated rate. However, financing costs are not deductible for PRRT purposes.

The PRRT generally limits transferring expenditure and losses between projects. In contrast, at the company tax level losses can be considered to be transferred between projects as tax is applied at the company/consolidated group level.

Why are PRRT projects taxed this way?

The PRRT was introduced as it was considered to be the most efficient way to deliver an appropriate share of the returns from developing resource projects to the community. Then-Treasurer Paul Keating released a joint media statement on 27 June 1984, which said “the arrangements decided upon represent a very reasonable balance between the objectives of satisfying the interests of the community as a whole in sharing in the benefits of very profitable offshore petroleum projects, and of providing companies with adequate rewards in return for the risks that they accept in undertaking offshore exploration and development activities.”⁵

As the Issues Note observes, the PRRT was introduced because existing royalty regimes were seen to discourage marginal projects being developed, with a negative impact on productivity and growth.

The PRRT is a rent-based tax, which is less likely to distort investment and production decisions because it applies to the risk-adjusted rate of return.

A more efficient tax is less likely to distort investment and production decisions, when raising a given amount of revenue. A less efficient tax can make some projects unviable that may otherwise be viable. Output-based taxes can mean some projects do not proceed, or they are not expanded, or they are closed earlier than would otherwise be the case.

The government should be focusing on whether an appropriate return is delivered over the life of a project, rather than expecting early upfront revenue. Output royalties tend to be predictable and do not vary with profits, while rent-based taxes can be more volatile. The best way to assess this is to consider the returns over the life of a project, which as discussed earlier, can be over extended periods of time.

⁵ ‘Resource Rent Tax on “Greenfields” Offshore Petroleum Projects’, Ministerial Statement, 27 June 1984.

Rents are difficult to identify and measure in both theory and practice

The PRRT was introduced to tax ‘the economic rent generated from a petroleum project’.⁶ Defining rents is the foundation on which the neutrality of rent taxes is made, but this is easier in theory than in practice.

The resources sector is a unique and complex area in this context, as the life of the resource is finite, extraction is limited to whoever holds the rights, there is some luck in the quality of the deposit and there is a clear potential to earn no or high returns. There is a great deal of risk and uncertainty and rents may be temporary (quasi-rents) as higher prices may encourage greater investment and dissipate these returns.

The design of the PRRT may also capture firm-specific rents, such as returns to know-how and expertise, which is not the intention of the tax. Rents may also diminish due to external factors such as project delays, changes in technology, policy instability and regulatory uncertainty.

The PRRT uplift rate for losses is crucial for neutrality

Rents may exist where the sale proceeds of resources exceed the costs of extraction, where costs include a threshold, risk-inclusive rate of return for the investment to go ahead. However, there is no standard investment project and no consensus on a standard rate of return to be reflected through the legislated uplift rate.

The return on a project will vary with the cost of capital, location risks, project-specific risks and business-specific risks. It can also vary over time as technology changes, new resource discoveries are made, substitutes to the resource are developed, or consumer preferences change.

The rate should be set such that investors are indifferent as to whether they receive the value of the tax deductions now or later. However, this is challenging due to the difficulty in measuring rents and in order to achieve neutrality, the government needs to be as well-informed about the profitability and uncertainty around a particular project as the investors themselves.

For this reason, the uplift rate includes a risk premium to compensate investors in the event that they never receive the tax value of the deduction, be it due to the nature of the project, or because transferral/refundability of losses is restricted.

It is difficult to determine a uniform uplift rate for every company, or even project. A uniform rate may mean some projects are over-compensated while more risky projects are under-compensated. The PRRT is well balanced by providing uplift rates as a risk premium above the long-term bond rate on the basis of the nature of the activity and for the reasons discussed above.

It might be tempting for governments to consider the uplift rate too high in hindsight, once some projects become ‘successful’. However, such an approach belies the fact that the decision to invest was undertaken on the probability of making a required rate of return, based on information at a certain point in time. But these numerous variables can, and

⁶ Explanatory Memorandum to the Petroleum Resource Rent Tax Assessment Amendment Bill 2011.

generally will, change after the final investment decision is taken. Some projects will perform better than initially expected and some worse – none is likely to deliver exactly what was anticipated based on initial probability assessments of the future.

It is also critical to recognise that investment decisions are undertaken based on the tax and policy settings at the time, with consideration for stability in these settings. Australia has traditionally been considered a safe environment for oil and gas investment, with a low level of sovereign risk. Indeed, this reputation helped foster the recent \$200 billion investment boom and should be maintained.

Australian companies pay a large amount of PRRT and other taxes

As the Issues Note observes, PRRT receipts averaged around 0.2 per cent of GDP throughout the 1990s and early 2000s, peaking at \$2.5 billion in 2000-01. Receipts averaged around \$1.5 billion a year over the past decade and are estimated to be around \$900 million a year over the forward estimates. As discussed previously, this reflects the unique stage of the industry's cycle.

PRRT is just one of many taxes applicable to the industry. When including company tax, PRRT projects can pay an effective tax rate of 58 per cent. Other taxes paid by the industry (depending on the location of the project and product produced) include crude oil excise, Commonwealth petroleum royalties, state and territory petroleum royalties and payroll tax.

Comparing taxes around the world is not straightforward

There is a tendency to compare taxes across jurisdictions to assess the level of taxes paid in different countries. Such comparisons are complex and need to be carefully considered. The costs of any resource project will reflect many unique factors and any comparison of the level of taxes paid should take these into account. Potential issues include:

- The characteristics of the project, including technical, geological and operational factors. Project characteristics differ across Australia, let alone the world. Australian LNG projects, such as for coal seam gas, were a world-first and as such presented different challenges to those based on conventional offshore resources.
- The stage of the project life cycle. Is it new or mature? Have costs been recovered?
- Are taxes like-for-like? How do tax systems compare? Is the taxing point the same? What other taxes are paid?
- Geography – is the area remote or close to urban areas? Is climate an issue, such as cyclones? Are there environmental considerations, such as nature reserves?
- Differences in input costs, including those driven by labour market conditions and workplace regulations, and broader regulations including environmental regulation.
- How do taxes compare over the life of a project?

3. There is no case for changes to the PRRT

The Business Council does not believe that there should be any changes to the operation of the PRRT. The review would need to find demonstrable net benefits from doing so, taking into account potential chilling effects on new investment and impairing international competitiveness.

Retrospective changes to taxation of existing projects (including any adjustment of the PRRT as it applies to those projects on a go-forward basis) would undermine investor confidence and be at odds with the government's focus on improving international competitiveness, including through the Enterprise Tax Plan. The capital for resource investments on which Australia relies is highly mobile across different countries and industries.

The stability and certainty of the existing regime helped to encourage over \$200 billion worth of investment over the past few years. Investment and operational decisions will be distorted by heightened fears of governments imposing additional and unexpected changes and creating sovereign risk, with the consequence that marginal projects may not proceed. For example, policy changes in Alaska and Alberta contributed to a decline in petroleum-related activity and a loss of investor confidence in the stability and predictability of their regimes.⁷

Short-sighted changes that seek to extract more revenue from existing projects also risk deterring new investments or expansions of existing investments. Critically, this would come at a time when the next wave of investment needs to be encouraged and unlocked.

Current PRRT outcomes are a design feature, not flaw, of the tax

The current outcomes around the PRRT are essentially a result of the deliberate design features of the tax. Revenues are reflective of project characteristics and lifecycles as well as broader market developments that influence global prices. As noted earlier, there has been a confluence of factors – volatile and subdued prices, production declines in some older projects and the large amounts of investment that are now deductible – which explain a period of lower tax revenues (and lower economic returns for project proponents).

This is why it is crucial that PRRT revenues are assessed over the life of projects. The advantage of the tax over an output-based royalty – and the principal reason for its introduction – is to raise revenues without discouraging investment in marginal projects.

While the lead-time of projects may have changed with more LNG projects, the fundamental rationale for the design features of the PRRT remains. That is, both investor and government will receive an appropriate return from projects at maturity when costs are recovered and there is a likelihood that project proponents are earning economic rents.

⁷ Agalliu, I. 2011, Comparative assessment of the federal oil and gas fiscal systems, U.S. Department of the Interior, Bureau of Ocean Energy Management Herndon, VA, OCS Study, BOEM 2011-xxx. 300 pp.

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