



## **SUBMISSION TO THE SENATE INQUIRY ON MINING / PETROLEUM RESOURCE RENT TAX**

**26 October 2010**

### **KEY POINTS**

- Australia's tax arrangements should recognise the vital role of domestic gas supply to Australia's economy.
- A 40% PRRT could make domestic gas projects uneconomic and cause a reduction in domestic supply.
- The PRRT could lead to even higher energy prices in Australia if producers passed-through the cost of the PRRT to local customers.
- Exempting domestic gas production from the PRRT would provide a significant incentive for gas producers to develop domestic gas supply.
- Other options also available to government could include:
  - a 150% or 175% exploration uplift for domestic gas projects – similar to that previously available for “frontier” deep water exploration;
  - a \$50 million threshold before any PRRT cuts in – similar to that proposed for the MRRT;
  - increased deductibility for development costs – for example, unconventional tight gas projects involve higher wellhead development costs compared to conventional gas fields; and
  - a Flow Through Shares Scheme – which would make it easier for smaller, emerging domestic gas producers to raise development funds.
- It is important that the Commonwealth support, or at the very least not undercut, the WA Government's royalty incentives for domestic gas.
- Any revenue foregone by the Commonwealth in incentivising domestic gas production would be more than offset by taxes generated by growth in downstream industries dependent on natural gas supply.

## The DomGas Alliance

The DomGas Alliance welcomes the opportunity to provide a submission to the Senate Select Committee's Inquiry into a national mining / petroleum resource rent tax.

The Alliance is Western Australia's peak energy user group and represents natural gas users, infrastructure investors and prospective domestic gas producers. The Alliance promotes security and affordability of gas supply.

Alliance members represent around 80 percent of Western Australia's domestic gas consumption and transmission capacity, and supply gas and electricity to 200,000 small businesses and 2 million West Australians.



## **The importance of gas supply to the Australian economy**

Natural gas supply plays a critical role in Australia's economy. According to ABARE, natural gas supplies almost a quarter of Australia's energy needs. The share of natural gas in Australia's energy consumption has increased in the past 30 years and this trend is likely to continue in the longer term.<sup>1</sup>

By 2030, Australia will depend on natural gas for one-third (33 per cent) of its primary energy.<sup>2</sup> This underlines the importance of Australia's taxation arrangements supporting, or at least not discouraging, domestic gas supply.

Natural gas is also vital in underpinning Australia's transition to a lower carbon economy during the next 20 years. Natural gas produces less than half the greenhouse emissions compared to coal and uses proven, readily available technology.

Only natural gas plants can provide the peaking power capacity necessary to support renewable power such as wind and solar, and make renewable energy a feasible energy source for the Australian market.

Western Australia is Australia's most gas-dependent economy. Natural gas fuels over 50 per cent of the State's primary energy and 60 per cent of its electricity generation. The WA gas market is bigger than NSW, the ACT and Queensland's combined.

Continuing gas supply underpins key value-adding industries such as alumina, chemicals, fertiliser, manufacturing and other resource-processing industries. It also underpins investment in potential new industries such as magnetite production.

## **Australia's tax arrangements should encourage domestic gas supply**

Given the importance of natural gas to the Australian economy, Australia's tax arrangements should encourage, or at the very least not discourage, domestic gas supply.

There is a need to avoid unintended consequences where a new tax causes a reduction in domestic gas supply or discourages potential domestic gas projects.

This is vital given Western Australia's current and worsening gas shortage. According to WA government and industry projections, WA faces a domestic gas shortfall of up to 600 terajoules per day over the next decade.<sup>3</sup> The State currently consumes almost 1000 TJ/d of gas.

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<sup>1</sup> ABARE, *Energy in Australia 2010*, p.12.

<sup>2</sup> ABARE, *Australian Energy Resource Assessment*, 2010, p.86.

<sup>3</sup> See for example, WA Department of Mines and Petroleum, *Petroleum in Western Australia: September 2010*, pp.20-22

## A 40% PRRT could make domestic gas projects uneconomic

In 2008, the Alliance commissioned a leading national accounting firm to assess the impact of different taxation scenarios on domestic gas supply. A copy of the Alliance fiscal incentive report is provided.

The report found that a 40% resource rent tax or PRRT would render both a near-shore domestic gas project and an onshore tight gas project uneconomic.

For a near-shore domestic gas project, project NPV after-tax cash flows would be -\$70 million over 10 years. This compares to a base case scenario of \$55 million. Over 20 years, project NPV would be -\$101 million compared to \$18 million base case.<sup>4</sup>

For an onshore tight gas project, project NPV would be -\$0.3 million over 10 years. This compares to a base case scenario of \$70 million. Over 20 years, project NPV would be \$35 million compared to \$119 million base case.<sup>5</sup>

Given the impact on potential domestic gas projects, domestic gas production should be exempted from the proposed PRRT. This would provide a significant incentive for gas producers to develop further domestic gas supply, while avoiding unintended consequences of making potential projects uneconomic.

**Table: Impact of 40% PRRT**

	NPV of 10 years after-tax cash flows (\$M)	% impact on NPV	NPV of 20 years after-tax cash flows (\$M)	% impact on NPV
<b>Near-Shore Domgas Project</b>				
Base case	55.96		18.52	
Resource Rent Tax (40%)	-70.84	-226.60%	-101.75	-649.45%
<b>Onshore Tight Gas Project</b>				
Base case	70.31		119.76	
Resource Rent Tax (40%)	-0.33	-100.47%	35.41	-70.43%

<sup>4</sup> DomGas Alliance, *Promoting Domestic Gas Exploration and Development: Tax, Royalty and Investor Incentives*, November 2008.

<sup>5</sup> DomGas Alliance, *Promoting Domestic Gas Exploration and Development: Tax, Royalty and Investor Incentives*, November 2008.

## **The PRRT could lead to an increase in energy prices**

In a WA market characterised by an absence of competition, there is a real risk that producers would simply pass on the cost of the PRRT to customers. This would be contrary to the government's intent that the PRRT would be a tax on the resource and not flow through to prices to Australian consumers.

In 2008, the Commonwealth removed the excise exemption on condensate production. The North West Shelf producers indicated in response that they would pass-on the impact of the tax to domestic gas consumers, as opposed to overseas LNG customers or condensate customers.

There is a need to ensure that there is no pass-through of the PRRT to domestic consumers. Such a pass-through could lead to even higher energy prices and make local industry unprofitable.

## **Other incentives**

The Alliance strong preference is that domestic gas production be exempted from the PRRT. The Alliance however recognises that other options are also available to government both within and outside the PRRT framework.

These options could include:

- a 150% or 175% exploration uplift for domestic gas projects – similar to that previously available for “frontier” deep water exploration;
- a \$50 million threshold before any PRRT cuts in – similar to that proposed for the MRRT;
- increased deductibility for development costs – for example, unconventional tight gas projects involve higher wellhead development costs compared to conventional gas fields; and
- a Flow Through Shares Scheme – which would make it easier for smaller, emerging domestic gas producers to raise development funds.

The Alliance's 2008 report examined for example the possible impact of a 175% uplift in pre-wellhead expenses. The uplifted tax deduction would be available to companies once the expenditure is incurred, and the companies would not have to develop gas before they received the tax incentive. The impact would be to reduce companies' taxable income and provide an incentive to companies with an existing tax liability.

According to the modelling, a 175% uplift a 43% positive impact on the 10 year NPV of a near-shore domgas project. For an onshore tight gas project, the incentive would result in a 4% positive impact on NPV.<sup>6</sup>

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<sup>6</sup> DomGas Alliance, *Promoting Domestic Gas Exploration and Development: Tax, Royalty and Investor Incentives*, November 2008.

It should be noted that this scenario does not take into account the potential negative impact of a 40% PRRT discussed earlier.

**Table: Impact of 175% uplift incentive**

	<b>NPV of 10 years after-tax cash flows (\$M)</b>	<b>% impact on NPV</b>	<b>NPV of 20 years after-tax cash flows (\$M)</b>	<b>% impact on NPV</b>
<b>Near-Shore Domgas Project</b>				
Base case	55.96		18.52	
175% uplift for pre-wellhead expenses	79.03	+41.23%	41.59	+124.6%
<b>Onshore Tight Gas Project</b>				
Base case	70.31		119.76	
175% uplift for pre-wellhead expenses	73.60	4.68%	123.06	2.75%

### **The WA Government has provided royalty incentives for domestic gas production**

The WA Government has recognised the importance of domestic gas and the need to provide tax and royalty incentives for domestic gas exploration and supply.

In July 2009, the WA Government announced a reduction in the State royalty rate on onshore unconventional “tight gas” production from 10 per cent to 5 per cent. It is important that the Commonwealth support, or at the very least not undercut, the State’s efforts to encourage domestic gas supply.

### **The potential impact on Commonwealth revenues**

Any revenue foregone by the Commonwealth in incentivising domestic gas production would be more than offset by the taxes generated by growth in downstream industries dependent on domestic gas supply.

For example, there are over 40 new resource projects in WA alone potentially needing gas supply. Together, these projects could deliver \$46 billion in new capital investment, \$25 billion a year in economic output, generate 19,000 jobs, and provide millions in government tax revenues.<sup>7</sup>

<sup>7</sup> Economics Consulting Services, *Western Australia Natural Gas Demand and Supply Forecast*, 2010.

The impact on Commonwealth revenues from providing a PRRT exemption or other tax incentives to domestic gas production is therefore expected to be modest.

Secure and affordable gas supply is an issue of vital importance to the Australian economy. The Alliance supports the Senate Committee's inquiry into ensuring that Australia's tax arrangements encourage, or at the very least not discourage, domestic gas supply.

## Appendix: DomGas Alliance Report on Tax, Royalty and Investor Incentives for Domestic Gas, 2008

Figure: Results of Scenario Modelling

### Near-shore DomGas Project

Scenario	NPV of 10 years of after tax cash flows (\$M)	% impact of incentive on NPV	NPV of 20 years of offer tax cash flows (\$M)	% impact of incentive on NPV
1 Base case (no incentives)	55.96	na	\$18.52	na
2 Reduce royalty rate to 5%	89.79	60.46%	\$57.14	208.56%
3 Royalty holiday until 2015	101.08	80.64%	\$63.64	243.68%
4 Rebase commodity value for OPEX and depreciation	59.70	6.69%	\$22.26	20.21%
5 Resource Rent Royalty (40%)	-70.84	-226.60%	-\$101.75	-649.45%
6 Uplift in pre-well head expenses 175% allowable tax deduction	79.03	41.23%	\$41.59	124.60%
7 Reduce statutory cap on effective life of pipeline to 10 years	60.48	8.07%	\$22.63	22.21%
8 Provide 3 year cash grant to offset CAPEX	79.18	41.49%	\$41.73	125.37%

### Onshore Tight Gas Project

Scenario	NPV of 10 years of after tax cash flows	% impact of incentive on NPV	NPV of 20 years of offer tax cash flows	% impact of incentive on NPV
1 Base case (no incentives)	\$70.31	na	\$119.76	na
2 Reduce royalty rate to 5%	\$91.48	30.12%	\$144.13	20.35%
3 Royalty holiday until 2015	\$97.11	38.13%	\$146.57	22.38%
4 Rebase commodity value for OPEX and depreciation	\$84.50	20.19%	\$135.69	13.30%
5 Resource Rent Royalty (40%)	-\$0.33	-100.47%	\$35.41	-70.43%
6 Uplift in pre-well head expenses 175% allowable tax deduction	\$73.60	4.68%	\$123.06	2.75%
7 Reduce statutory cap on effective life of pipeline to 10 years	\$71.24	1.32%	\$120.83	0.97%
8 Provide 3 year cash grant to offset CAPEX	\$73.96	5.19%	\$123.41	3.05%