

An Inquiry into Australia's oil and gas reserves

Senate Standing Committees on Economics

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Summary

1. Norway has the best system for maximising the benefit to the public of national oil and gas reserves.
2. Their system comprises three main methods for capturing the economic surplus created:
 - a. the petroleum tax system (including company tax, a special rate petroleum tax, and royalties)
 - b. direct ownership stakes in private oil produces, and
 - c. profits from the publicly owned oil company, Equinor (formerly Statoil).
3. In contrast, Australia has an ineffective special rate tax on petroleum (the Petroleum Resources Rent Tax, or PRRT, which was the subject of a previous inquiry), no public oil company, and no direct ownership stake in private oil and gas companies that are extracting its national resources.
4. Additionally, Australian consumers of gas derive no benefit in the form of lower costs while the east coast gas market is connected to the global market. A domestic reservation policy ensures that local gas customers benefit from Australia's natural resource endowment. Western Australia has such a policy that has kept gas costs below half of the growing east coast cost.
5. These arrangements can be replicated in Australia. However, any change is going to affect the property rights previously granted to private oil and gas companies.
6. Where States have jurisdiction over oil and gas reserves (such as coal seam gas), they can enact the policies recommended here. Otherwise, the Commonwealth government can. Ideally, there would be national harmonisation of new tax changes.
7. A workable policy change is to
 - a. Require equity issuance to State governments (or Commonwealth) calculated as a proportion of total revenues in that year, say 5%. That means a company that sells \$100 million of gas issues additional shares to the State that have a market value of \$5 million. This proceeds until ownership is diluted for every company so that governments own 30% of the total equity.
 - b. Remove tax loopholes that allow excessive carry-over and escalation of costs in the tax base for the existing PRRT.
 - c. Enact a domestic reservation policy on the east coast of 50% of all gas.

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PART 1: Comments to specific items in the Terms of Reference

a. arrangements used by other countries to maximise the benefit to the public of national oil and gas reserves

Australia is a resource-rich nation that has only minimally attempted to recoup the value of the public's vast natural resources, despite being wealthy and politically stable. This has led to Australian governments at both the State and Federal levels missing out on a share of the windfall gains from a resource boom that began in 2004-05 and has subsequently unwound in terms of prices, but with elevated export volumes.

Total average annual revenues from the Commonwealth resource tax system on oil and gas were just \$2.7 billion per year during this historic boom period, while oil and gas producers reported \$33.5 billion in annual revenues on average and \$8.2 billion in annual profits.

This surprising low share of the value of the final oil and gas products, just 10% for all forms of resource taxation combined¹, is a product of overly generous exemptions and accounting practices that undermine each of the three main components of this Commonwealth resource tax system; gas royalties, crude oil excise tax and the Petroleum Resources Rent Tax (PRRT). The PRRT itself has seen its share of profits taxed fall from around half prior to 2000, to less than 20% since 2010 (despite it applying on profits at a rate of 40%).

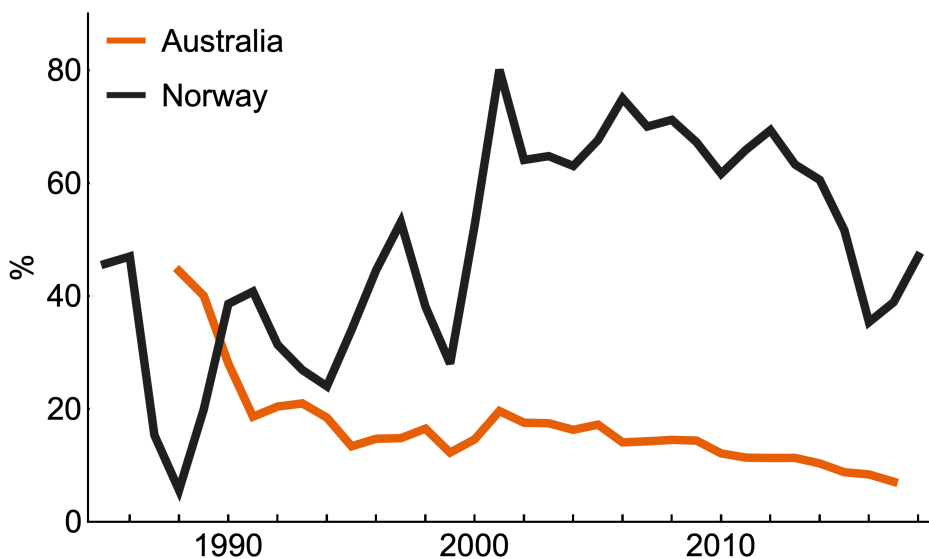


FIGURE 1: PUBLIC OIL AND GAS REVENUES AS A PERCENT OF EXPORT REVENUE (APPEA, 2016; STATISTICS NORWAY, 2016)

This situation stands in stark contrast to Norway, which runs an effective system to capture the economic value of its oil and gas resources for the public. Figure 1 shows that as a share of export value, Norway's system provides exceptionally higher returns to the public. In the boom period, Norway exported NOK 555 billion in oil products per year on average, with the

¹ Including the share of royalties from the North West shelf oil project area that are shared with Western Australia.

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government reclaiming NOK 349 billion in taxes and payments for the Norwegian people; an astonishing 63% of total industry revenues.

A divergence between the rigorous resource taxing regime for oil and gas in Norway and the relatively light-handed taxation in Australia began in the mid-1990s.

One of the reasons for this is that Australia relies heavily on the profit-based PRRT, and declared profits plummeted in recent years despite near record high revenues. This is a product of depreciation, exploration costs, and other accounting losses being booked.

It is also important to keep in mind in any comparison with Norway that Australia's oil and gas reserves are not as cheaply accessible and require much higher extraction costs. That means that any profits-based system is going to result in lower revenues, even if it encourages more gas extraction. It may be economically advantageous to simply charge a high royalty rate on revenue with lower production rates but over a longer time period (as discussed in my submission to the PRRT Inquiry in 2017).

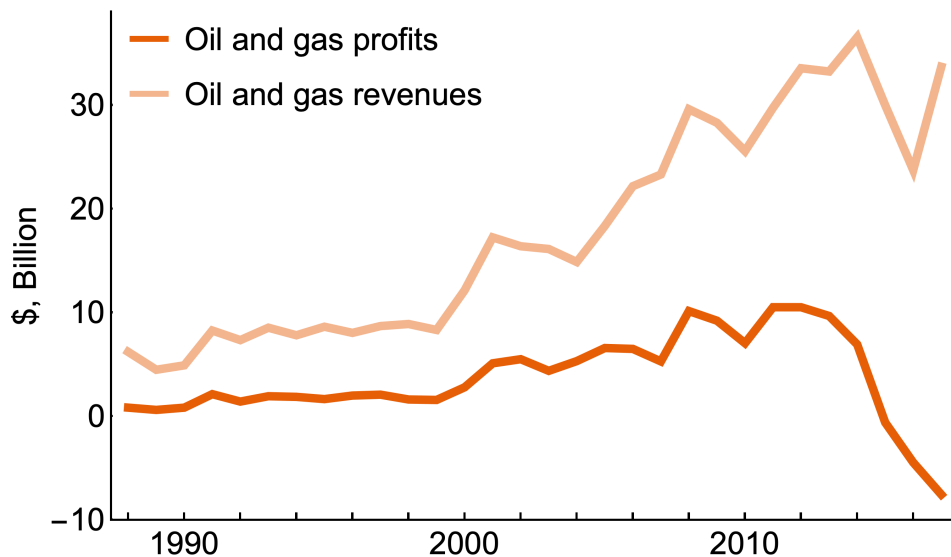


FIGURE 2: AUSTRALIAN OIL AND GAS PROFITS ARE NEGATIVE EVEN THOUGH REVENUES ARE SOARING

The Norwegian system comprises three main methods for capturing the economic surplus created:

- a. the petroleum tax system (including company tax, a special rate petroleum tax, and royalties)
- b. direct ownership stakes in private oil companies, and
- c. profits from the publicly owned oil company, Equinor (formerly Statoil).

The bulk of the benefit returned to the public comes from the petroleum tax system and the direct ownership stake, known as the State's Direct Financial Interest (SDFI). Revenues from each source are outlined in Figure 3.

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Norway's petroleum tax system is similar to Australia's PRRT. It charges the ordinary company tax rate of 22%, and the special tax rate is 56%, to give a marginal tax rate of 78% on oil and gas companies.

This means that tax revenues are highly pro-cyclical compared to royalties, as Figure 3 shows.

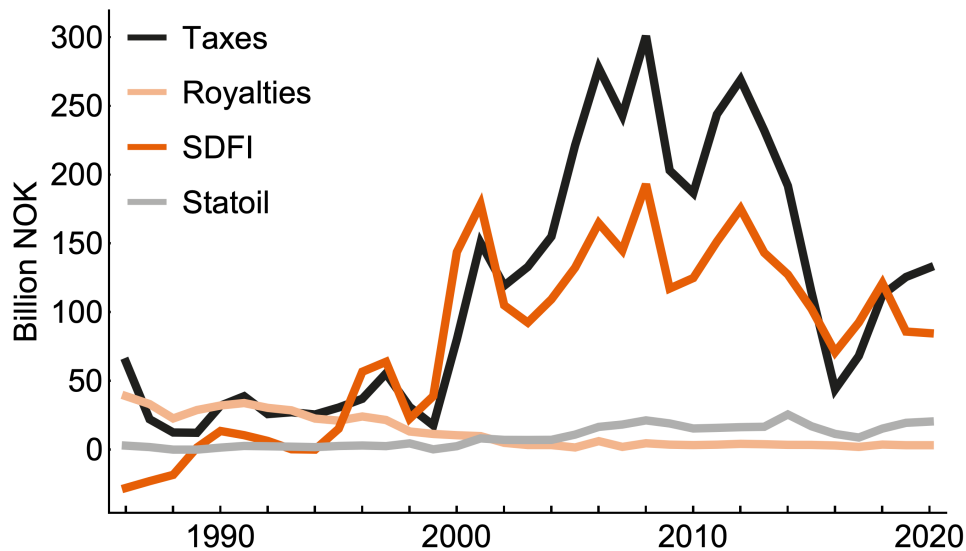


FIGURE 3: NORWEGIAN STATE REVENUE COMPOSITION FROM OIL AND GAS (STATISTICS NORWAY, 2016)

Norway's SDFI is best thought of as a "tax-dodging insurance policy" as well as a tax-enforcement mechanism. Because the Norwegian state requires that they participate as an equity holder in oil field development, with the State holding company Petoro typically holding at 30% stake (Petoro, 2019), they get significant influence as a shareholder (to lobby for cooperation with tax authorities). If the company does minimise its tax, the government earn 30% of that lost tax back from its shareholder profits.

One of the limitations Australia in comparison with Norway when it comes to oil and gas taxation is our profits-based PRRT is relatively ineffective, especially with it's a) generous carry-over and cost escalation allowances of 15% above the long-term bond rate (compared with Norway's 5.4% allowance), b) allowances for frontier exploration, c) transferability of deductions, and d) asset rebasing allowances (Murray, 2017). This needs reforming and extremely rigorous accounting oversight.

b. arrangement that could be considered to maximise benefit to the public of Australia's national oil and gas resources, cognisant of:

- i. sovereign risk,**
- ii. existing property rights, and**
- iii. federal and state jurisdictions; and**

Any change to the way in which the benefits of natural resource endowments are distributed is going to entail changes to the property rights previously given to oil and gas companies.

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This should not be a concern. Tax rules and regulations always change, not just in the resources sector, but in all sectors of the economy. It is one of the built-in risks.

Additionally, the Inquiry and the federal government should prioritise practicality of implementation and minimisation of tax avoidance, over and above considerations of economic efficiency. After all, any inefficiency in the sector will simply result in the resource being left in the ground to be utilised at some future date. The economic losses from using a blunt instrument like royalties, over a subtle and difficult to enforce instrument like the PRRT, may not be very large if poor PRRT design undermines the resource rent base it should be taxing.

Lastly the Inquiry and the federal government should not be influenced by the flawed argument around the 'retrospectiveness' of changes to tax regimes and sovereign risk. Such myths plagued past reforms of the resources tax system, such as the implementation of the Resource Super Profits Tax (RSPT), allowing generous exemptions and concessions to persist. These are nothing more than a gift of the economic rent the PRRT is meant to tax that are given to the lucky few resource companies who were historically dealt a favourable hand.

c. any related matters.

A key benefit from natural resource endowments is a lower cost of domestic users of that resource. Yet since the Australian east coast gas market has become connected to the global market, with 2015 completion of the Curtis Island LNG facility, the price advantage has been lost. Figure 4 shows clearly that East Coast gas prices are now 77% higher than domestic gas users in Western Australia (WA) are paying, as the WA government requires 15% of gas produced to be reserved for domestic use. With a relatively small domestic market, this small reservation has a large price effect, and flow-on benefits for the competitiveness of their manufacturing and mining sectors, which rely heavily on gas for commercial applications.

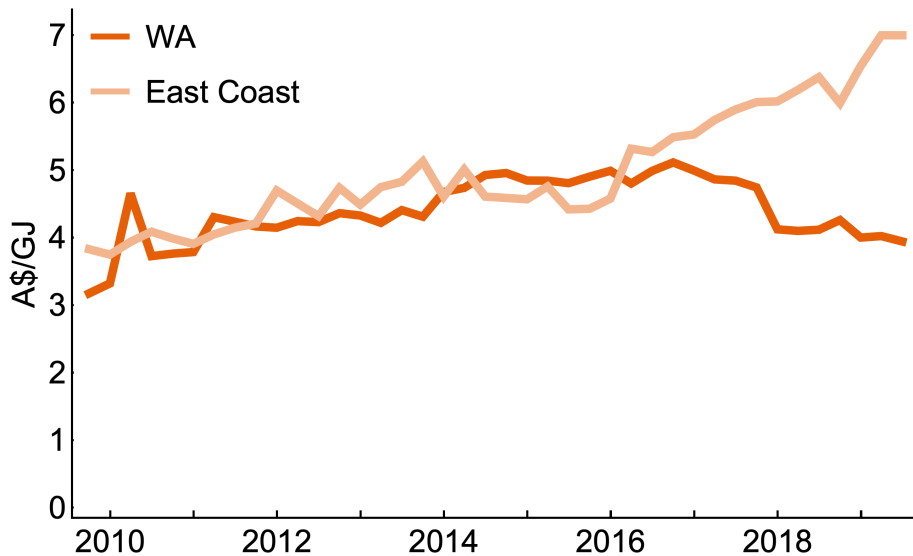


FIGURE 4: COMPARISON OF WHOLESALE GAS PRICE ON AUSTRALIA'S EAST COAST AND IN WESTERN AUSTRALIA (DMIRS, 2019)

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Part 2: Recommendations

The policy changes recommended here are based on the effectiveness of the experience in Norway and Western Australia. They are:

- a. Require equity issuance to State governments (or Commonwealth) of resource companies with oil and gas extraction rights. The amount of equity should be calculated as a proportion of total revenues in that year, and set at a low level, such as 5%. That means a company that sells \$100 million of gas issues additional shares to the State that reflect a market value of \$5 million. Based on recent revenues that would be around a \$1.5 billion per year issuance. This proceeds until ownership is diluted for every company so that governments own 30% of the total equity (apportioned by project where necessary) in the resource companies that use our national resources.

For future projects, governments can force oil and gas companies to take them as an equity partner, but with share ownership disproportionately favouring the government's financial contribution. A 2:1 equity stake could be required, wherein the government contributes 15% of costs but is given a 30% equity stake. This ensures a positive return to the community and incentivises the prioritisation of the highest value oil and gas reserves.

- b. Enact a domestic gas reservation policy on the east coast for 50% of all gas, to go much further than the policy in Western Australia to account for the larger domestic market relative to total production. This can be enacted immediately.
- c. Enact 10% royalty on the market value of all oil and gas projects at domestic prices to replace all Commonwealth resource revenues from the suite of PRRT, crude excise and royalties. This would be simple to enforce and likely raise more revenues in the next decade as the industry unwinds from a large exploration phase compared to the current setup.

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