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The Hon Geoff Prosser MP
Chairman
House of Representatives Standing Committee
on Industry and Resources
Parliament House
Canberra ACT 2600

Dear Chairman

Inquiry into Exploration Impediments – Supplementary Submission by the Australian Petroleum Production & Exploration Association

As you would be aware, the Australian Petroleum Production & Exploration Association (APPEA) appeared before your Committee on 21 October 2002 in Canberra. At that time, APPEA indicated that it was nearing the finalisation of a set of recommended changes to the taxation system that are intended to improve the framework for future exploration and development in the Australian oil and gas industry.

I can confirm that APPEA has completed its review and is pleased to indicate that the following changes are recommended to the fiscal framework:

1. Under the **petroleum resource rent tax** (PRRT):
   - general project cost uplift rate be increased from the LTBR plus 5 percentage points to a minimum of the LTBR plus 10 percentage points;
   - introduction of a barrel of oil equivalent exemption for all future field developments; and
   - GDP factor rule be adjusted for exploration costs incurred greater than five years prior to the application for a production licence.

2. For **company income tax** purposes:
   - introduction of an 'exploration premium' for expenditures in government nominated acreage in high risk or frontier areas at a rate of up to 175%; and
   - adjust the tax provisions to assist in unlocking exploration deductions for companies which directly hinders their ability to attract capital via a share flow through system for investors.

The recommended changes are focused on elements of the direct and resource taxation systems that impact on exploration and/or development decisions in the petroleum exploration and development industry. APPEA considers it essential for both exploration and development elements of the decision making process to be addressed, as both elements are interdependent in the overall decision making process.

Details of the Recommended Changes

<u>Petroleum Resource Rent Tax</u>

The PRRT framework fundamentally influences exploration and development decisions taken in offshore areas. A number of changes to the regime that have been made since its initial introduction have improved its focus, while others have had a negative impact on development decisions. Because of the dynamic nature of the regime, different pressure points exist for companies that necessitate changes to be focussed at different aspects of the regime.

APPEA proposed enhancements to the regime in 1997 that dealt with a number of concerns that had been identified by industry. The Federal Government responded positively with respect to the need to clarify the provisions for integrated projects (the final details of the gas transfer pricing methodology are currently the subject of discussion), while a relatively minor modification was made to an aspect of the exploration provisions. APPEA considers that these earlier proposals, which largely form the basis of the recommendations outlined below, must be revisited.

PRRT Uplift Rate for General Project Costs

The carry forward rate that applies to undeducted general project costs is a crucial parameter in the PRRT framework as it has a significant impact when a PRRT liability is first incurred for a project. The rate was reduced in 1991 from the long term bond rate (LTBR) plus 15 percent points to the LTBR plus 5 percentage points at the same time as the wider deductibility provisions were implemented.

APPEA advocates an increase in the PRRT uplift rate for general project costs for new (oil and gas) projects to a minimum of the long term bond rate plus 10 percentage points. APPEA members are of the view that this modification is essential to improve the economics of marginal projects. At the present time, there is a widely held view that a PRRT liability can be incurred prior to an adequate risk adjusted return is generated by an investor.

Such a change will significantly aid the economics of potential new gas projects, which are generally characterised by long pay back periods. At the same time, such a change would have a relatively minor revenue cost to government for new oil projects, as these types of developments tend to utilise project development costs relatively quickly. Importantly, the same uplift provisions would therefore apply for all future project costs, thereby avoiding any potentially complex technical and compliance requirements.

Barrel of Oil Equivalent Exemption for New Developments

APPEA's call for a barrel of oil equivalent (boe) exemption was not accepted in 1998, in part because it was argued that the existing provisions were considered to be flexible enough to accommodate the range of offshore operating environments and also because such an approach was thought to sit uneasily with the conceptual basis of the PRRT regime. There was also a concern about the creation of 'artificial distinctions' that, it was suggested, would become redundant over time.

APPEA members consider that the introduction of boe exemption for all future field developments would greatly assist the go-ahead of new projects and, just as importantly, extensions to existing projects. Importantly, such a regime would avoid the need to arbitrarily set up a system that was based on potentially subjective criteria. The level of the exemption need only be set at a relatively modest level, and importantly, will provide parity with the similarly positive initiative introduced under the crude oil excise regime in the late 1980's.

APPEA considers that the exemption should apply to both oil and gas projects. The major benefits associated with the introduction of such an arrangement are that is would assist positive exploration decisions and provide a stimulus to new field extensions to existing projects. Under the current provisions, such developments can be disadvantaged because the PRRT paying position of the wider project can render the economics of new field extensions as being sub-economic.

Exploration Carry Forward Provisions : GDP Factor Rule

The existing five year provision is, in APPEA's view, inadequate. The time frame over which an investor is able to explore and submit all of the information relevant to the granting of a production licence application is often going to be significantly greater than five years, particularly for gas discoveries. This is has been exacerbated as a result of the increased regulatory requirements that companies must now comply with. As such, the continuation of the existing rule that allows only five years for the process to be completed must be re-examined. The direct result of the current provision is that it introduces an unfair distortion against investors whereby the value of exploration deductions is artificially distorted downwards.

It is recommended the GDP factor rule should be adjusted to ensure that for exploration expenditure incurred more than five years prior to a company applying for an initial production licence, such expenditure should be compounded forward at the augmented bond rate (LTBR plus 15 percentage points) for the most recent five years. For periods in excess of this time, a rate should apply that keeps the deductions constant in real terms (through the application of an interest rate or CPI adjustment mechanism).

Corporate Tax System

Introduction of an 'Exploration Incentive' for High Risk Exploration

APPEA has been concerned for a period of time that the increased risks that are associated with exploration in deepwater and some onshore areas are not adequately dealt with under the company income tax system. Additional risks that exist in these areas include:

- poorly understood geological frontiers;
- leading edge technology is required;
- low commercial success rates;
- exploration costs are higher;
- high cost appraisal work is required to mitigate against development risks which regularly results in 'no-go' decisions;
- extensive reservoir modelling and design work is required to optimise development concepts; and
- in deepwater areas, new technology is required (heated flow lines, high pressure subsea equipment etc) and specialist construction techniques need to be used.

In effect, the current provisions provide an in-built bias that encourages investors to focus their attention towards conventional, less risky areas. Industry considers that a strong case exists for the introduction of an 'exploration premium' under the company tax system for government nominated acreage (both offshore and onshore) to reduce the bias against exploration in high risk or frontier areas. This premium would be akin to the high intensity research and development provisions that presently exist in the company tax system and could be set at a rate of up to 175%.

Indeed, it is arguable that such exploration could fit within the intended definition of research and development as much of the envisaged activity is systematic, investigative, experimental and involves innovation. High levels of technical risk exist and new knowledge is acquired.

APPEA would envisage a system applying whereby the Federal Government, in consultation with industry, would nominate selected acreage (both onshore and offshore) during the normal acreage release processes. Acreage would be categorised as 'high risk' or 'frontier' in nature and therefore would be eligible for the application of the exploration premium. Companies expending exploration funds within these nominated areas would be eligible for a 'bonus' in relation to company tax deductibility, at the applicable rate.

Any discoveries as a result of this mechanism would quickly recover the cost of this tax deduction both directly and via multiplier effects, and moreover encourage more new exploration in other remote areas.

The quantum of the bonus acreage would in all likelihood represent a relatively modest percentage of the total acreage released. Nevertheless, it would represent an important initiative to assist in 'levelling the playing field' for exploration decisions across high risk and low risk areas.

Capital Access Impediments : Unlocking Undeducted Exploration Costs for Junior Explorers

In many respects, the health of the entire oil and gas industry is directly related to the strength and vitality of the junior exploration sector of the industry.

There has been a well documented and consistent reduction in the level of exploration onshore. Junior exploration companies often find themselves limited in capital and hence they are required to focus on marginally prospective acreage with consequent lower success rates. Nonetheless, these companies have in the past opened up new oil prone areas that have become important to the industry. The appetite of the capital markets to provide such companies with additional capital would be significantly enhanced if the company tax system was not biased against them.

The company income tax laws presently allow for the immediately deducibility of costs associated with exploration activity for the entity that incurs the expenditure. For companies that have an income tax liability, the ability to immediately expense such costs provides an important form of cost relief. Entities that do not have such income are unable to obtain tax relief and are therefore required to carry forward costs. As a direct consequence, this inability to obtain a tax deduction significantly reduces the after tax value of exploration activity undertaken by these companies. While costs may ultimately be deducted when a tax liability is incurred, at best, the value is kept constant in nominal dollars and is therefore significantly eroded in real terms. Indeed, the deduction may never be utilised. **Advice from many junior exploration companies is that this has directly fed through to capital markets and diminished their ability to raise funds**.

In effect, the taxation system is behaving in a manner that makes this type of venture less attractive to investors, despite the fact that the economy wide benefits of such activities are ultimately very large.

- A Possible Solution

In the past, public companies have had access to a number of schemes that allowed for the deductibility of petroleum exploration expenditures to be passed to shareholders. These schemes were generally regarded as having increased the exploration efforts of eligible companies. For example, in the 1960s and early 1970s, a petroleum company raising new capital could pass a tax deduction directly to each subscriber.

In the late 1970s, a rebate scheme was developed for certain offshore areas that was later expanded to cover onshore exploration. A number of restrictions were placed on the operation of this system, including allowing for deductions at rates that were considerably lower than the prevailing company tax rate and limiting the timing and scope for which the funds could be used. This scheme was subsequently terminated.

The industry is of the view that considerable merit exists for such a system, in one form or another, to be reintroduced. A modification to the tax provisions would assist in unlocking exploration deductions for companies. The outcome could best be achieved via a share flow through arrangement to equity shareholders. APPEA would see such a scheme as being limited to exploration undertaken in Australia, with the introduction of credible, transparent and appropriate anti-avoidance measures.

The advice APPEA has received from member and non-member junior oil and gas exploration companies strongly suggests that the implementation of such a scheme will lead to an expansion in the funds available for exploration activity in Australia. While difficult to quantify, APPEA estimates that the total level of petroleum exploration expenditure made by junior exploration companies is less than $100 million per annum. Of this amount, not all would be expended on exploration in Australia, and for some companies, a taxable income stream already exists that allows for the deductibility of such costs.

In this context, the cost to revenue of any prospective change would be modest, however it could realistically be expected to produce a significant boost to the overall petroleum exploration effort in Australia, with the corresponding regional development, employment and self sufficiency benefits. The industry would be pleased to work closely with your Committee and/or the relevant Government agencies to assist in the design of such a system.

APPEA would be pleased to further expand on any of the issues raised above with your Committee.

Yours sincerely

Barry Jones
Executive Director