

CHAPTER 3

SCHEDULE 5 – INCENTIVES FOR PETROLEUM EXPLORATION IN FRONTIER AREAS

Outline of Schedule 5

3.1 Schedule 5 of the bill, if passed, will amend the *Petroleum Resource Rent Tax Assessment Act 1987*, introducing provisions intended to encourage exploration for new petroleum (oil and gas) reserves in Australia's remote offshore areas. This measure was announced by the Treasurer and the Minister for Industry, Tourism and Resources, the Hon. Ian Macfarlane MP, on 11 May 2004.

3.2 The stated policy objective of the measure is 'to encourage petroleum exploration in Australia's remote offshore areas in order to discover a new petroleum province'.¹

3.3 The measure allows the Minister responsible for the *Petroleum (Submerged Lands) Act 1967* to allocate up to 20 per cent of the annual offshore petroleum acreage release areas as 'designated frontier areas'. Persons conducting exploration in these designated areas will be able to claim 150 per cent of the costs associated with their exploration expenditure (currently 100 per cent) for the purposes of determining the amount of Petroleum Resources Rent Tax (PRRT) payable. The incentive is limited to new exploration only—it will not apply to activities associated with evaluating or delineating previous discoveries.

3.4 The cost to the revenue of this measure is expected to be \$17 million over the period from 2004-05 to 2007-08.²

3.5 The Explanatory Memorandum for the bill notes that these amendments are being introduced in the context of concerns about Australia's declining oil reserves raised by the oil industry and by the House of Representatives Standing Committee on Industry and Resources' 2003 report, *Exploring: Australia's future*.

3.6 The Explanatory Memorandum further notes that while Australia has some 40 offshore basins that display petroleum potential, many remain unexplored, often because they are in deep water and far from existing infrastructure, making them difficult and expensive to explore. The amendments are intended to encourage exploration in these remote areas.

1 Tax Laws Amendment (2004 Measures No. 7) Bill 2004, Explanatory Memorandum, the Parliament of the Commonwealth of Australia, House of Representatives, p. 79.

2 Tax Laws Amendment (2004 Measures No. 7) Bill 2004, Explanatory Memorandum, the Parliament of the Commonwealth of Australia, House of Representatives, p. 83.

3.7 These exploration incentives are being introduced at a time when Australia's domestic reserves of oil are dwindling rapidly, increasing dependence on imports; and a low level of exploration for oil and gas is being undertaken, resulting in few new discoveries being made to replace reserves that are being run down.

Petroleum resource rent tax

3.8 The amendments proposed by the Government provide a measure of relief from PRRT, increasing (or 'uplifting') the amount that may be claimed in respect of exploration expenditure in the designated frontier areas from 100 per cent to 150 per cent.

3.9 The following section gives an abbreviated overview of the operation of the PRRT. The material is drawn from the ATO and ITR web sites.

3.10 PRRT was originally designed to ensure that the Australian community receives an appropriate share of the large returns that can follow the development of rich petroleum deposits, while providing companies with adequate rewards in return for the risks they accept in undertaking offshore exploration and development. It commenced on 1 July 1987.

3.11 This tax applies to all petroleum projects in offshore areas (or Commonwealth Adjacent Areas) under the *Petroleum (Submerged Lands) Act 1967*, other than production licences derived from the North West Shelf exploration permits WA-P-1 and WA-P-28. The latter are subject to the excise and royalty regime. The 'adjacent areas' extend three nautical miles from the territorial sea baselines to the outer limits of the continental shelf, other than areas covered by production licences granted on or before 1 July 1984 and permit areas that those production licences were drawn from. Other exemptions include permits in the Joint Petroleum Development Area (JPDA) with East Timor.³

3.12 PRRT is assessed on a project basis and is levied on the taxable profits of a petroleum project at a rate of 40 per cent. A 'project' consists of facilities in the project title area, and any facilities outside that area necessary for the production and initial storage of marketable petroleum commodities.⁴

3.13 'Taxable profit' is the project's income after all project and 'other' exploration expenditures, including a compounded amount for carried forward expenditures, have been deducted from all assessable receipts. PRRT payments are deductible for company tax purposes, currently at a rate of 100 per cent. Eligible expenditures include exploration and all project development and operating expenditures.

3 From ATO Website: www.ato.gov.au

4 From ITR Website: www.itr.gov.au

Closing-down expenditures, including offshore platform removal and environmental restoration, are also deductible in the year in which they are incurred.⁵

3.14 With the exception of a number of items, exploration expenditure incurred in areas covered by the PRRT is deductible against all projects held by that person subject to compliance with anti-avoidance provisions. In the case of a company in a company group, the expenditure will be deductible against all projects held by the group. This ensures that the pattern of exploration is not affected by taxation arrangements.⁶

3.15 Expenditures that are not deductible include financing costs, private override royalty payments, income tax, goods and services tax, fringe benefits tax, cash bidding payments and certain indirect administrative costs.⁷

3.16 In 2002-03, PRRT collections were approximately \$1.72 billion. The majority of this revenue came from the production of petroleum products in Bass Strait.⁸

Rising imports and declining reserves

3.17 Australia both imports and exports oil. Most domestically produced oil is light, and is not suitable for many applications, for example bituminous products and lubricants. Imports exceed exports by a substantial margin. In 2003-04, 23 649 million litres were imported and 17 660 million litres were exported. This margin is expected to widen, such that the proportion of imported oil in primary consumption will rise from 37 per cent in 1998-99 to 52 per cent in 2019-20.⁹ This change results from a combination of increasing domestic demand and declining domestic reserves.

3.18 Australia has substantial natural gas reserves but limited and declining oil reserves. Australian gas reserves represent about 2.2 per cent of the world's total, but oil reserves account for only 0.4 per cent of global reserves.¹⁰ Nonetheless, Australia has enjoyed a high level of self sufficiency in oil and gas for the last three decades. However, the rate of new discoveries of oil and gas has lagged behind rising domestic demand and we are increasingly dependent on imported oil.

3.19 Increasing dependence on imported oil has the potential to place further pressure on Australia's trade balance. Representing the Australian Petroleum Production & Exploration Association Limited (APPEA), Mr Barry Jones commented

5 From ITR Website: www.itr.gov.au

6 From ITR Website: www.itr.gov.au

7 From ITR Website: www.itr.gov.au

8 From ITR Website: www.itr.gov.au

9 Derived from Parliamentary Library Bills Digest No.111 for 2004-05.

10 Submission by Geoscience Australia to the House of Representatives Standing Committee on Industry and Resources Inquiry into Resources Exploration Impediments, p. 29.

that if current oil prices persist and the government's best supply forecast is met, imported oil would add 'about \$30 billion a year to the national export bill by 2015'.¹¹

3.20 The quantity of domestic crude oil reserves is subject to constant amendment, as new discoveries are made and existing stocks are drawn down. According to Geoscience Australia, reserves peaked in 1994, declined by 19 per cent by the year 2000, and are continuing to decline. Australia's current reserves of crude oil totalled 819 million barrels, with a further 671 million barrels of condensate¹² as at 1 January 2003, equivalent to about 5 years of consumption at current rates.¹³

3.21 There are also further known reserves that may be exploited in the future but which are currently regarded as non-commercial. About three-quarters (1 407 million barrels of a total of 1 859 million barrels) of these non-commercial reserves are in the form of condensate, and so require markets to be found for the associated gas before being exploited.¹⁴

3.22 Production declines as reserves diminish. Geoscience Australia expects production to decline by 40-50 per cent in the medium term and then to decline steadily even further.¹⁵

Declining exploration activity

3.23 Exploring for oil and gas is expensive. This is particularly so in the offshore frontier areas off Australia's coast, because drilling activity is carried out in very deep water. Estimates vary. Geoscience Australia costs a single offshore exploration in the region of \$8-10 million.¹⁶ APPEA advised that the cost of a deepwater exploratory well may exceed \$50 million.¹⁷

3.24 Australia is also considered a risky place to explore. Success rates are low compared to other countries. In a submission to the House of Representatives Standing Committee Inquiry into Resources Exploration Impediments, ExxonMobil cited a study conducted by international oil and gas consultants, Wood Mackenzie, which rated the world's top oil and gas producing regions:

11 *Proof Committee Hansard*, 1 March 2005, p. E12.

12 Condensate is a term used to describe hydrocarbons that exist as a gas in a gas field and which are separated out from the accompanying gases to form a liquid during production.

13 *Submission 2*, APPEA, p. 2.

14 Submission by Geoscience Australia to the House of Representatives Standing Committee on Industry and Resources Inquiry into Resources Exploration Impediments, p. 26.

15 Submission by Geoscience Australia to the House of Representatives Standing Committee on Industry and Resources Inquiry into Resources Exploration Impediments, p. 31.

16 Submission by Geoscience Australia to the House of Representatives Standing Committee on Industry and Resources Inquiry into Resources Exploration Impediments, p. 33.

17 *Proof Committee Hansard*, 1 March 2005, p. E12.

The study found that offshore Australia ranked 46th in the world in exploration drilling success, with a commercial success rate of a little over 6%. This compares with other locations such as Malaysia with a commercial success rate above 50% and Angola with over 40%.¹⁸

3.25 Nonetheless, substantial sums of money are being spent on exploration for oil and gas in this country. In 2002-04, explorers spent a total of \$995 million—\$191.3 million for on-shore exploration and \$803.7 million for offshore exploration. The amount spent fluctuates from year to year, the total spent in 2002-03 representing a 14.7 per cent increase over that spent in 1998-99.¹⁹

3.26 However, the overall trend for the last two decades has been for levels of exploration to decline, particularly when the number of wells drilled and quantity of seismic surveys carried out are considered.

3.27 In 2002, 88 wells were drilled, and 91 in 2003, a much lower level of activity than the peak of 267 wells drilled in 1985.²⁰ According to APPEA, the quantity of seismic survey work undertaken has also fallen dramatically since the peaks of the early 1990s.²¹

Prospects for future exploration

3.28 While exploration has declined, there appears nonetheless to be further exploration potential for new petroleum resources. Geoscience Australia notes that of the 40 Australian offshore basins, about half remain unexplored. The organisation notes that if Australia is to maximize the opportunity to maintain an indigenous liquid hydrocarbon supply, there is a need to extend the area in which Australian exploration occurs. However, the organisation sounds a note of caution, warning that the chance of finding large crude oil fields is limited.²²

3.29 The measure introduced by the Government recognises the need to extend exploration into previously unexplored areas. The Government has indicated that when specifying designated frontier areas, the relevant minister 'is likely to favour those areas which are at least 100 kilometres from a commercialised oil discovery and not adjacent to an area designated in the previous year's acreage release.'²³

18 Submission by ExxonMobil to the House of Representatives Standing Committee on Industry and Resources Inquiry into Resources Exploration Impediments, p. 3.

19 Australian Bureau of Statistics, Mineral and Petroleum Exploration Australia, 1301.0 – 2005.

20 From Geoscience Australia website, www.ga.gov.au/oceans/projects/q4_2003_apeda.jsp

21 *Submission 2*, APPEA, p. 4.

22 Submission by Geoscience Australia to the House of Representatives Standing Committee on Industry and Resources Inquiry into Resources Exploration Impediments, p. 31.

23 Tax Laws Amendment (2004 Measures No. 7) Bill 2004, Explanatory Memorandum, the Parliament of the Commonwealth of Australia, House of Representatives, p. 74.

3.30 The APPEA representative appeared somewhat pessimistic about whether the gap between supply and demand would be closed by further exploration:

I do not see exploration as closing the emerging demand-supply gap in this country. We will still have to do energy sufficiency measures, we will still have to look at demand-side management and we will still have to look at alternative fuels. To deal with that issue requires a suite of measures, of which more exploration is only one.²⁴

Environmental impacts

3.31 During the second reading debate in the House of Representatives, the Member for Hunter, Mr Joel Fitzgibbon, indicated that while the Opposition would not oppose the schedule and recognised the need for further exploration, environmental considerations required closer examination by the committee.²⁵ These considerations appeared to be based on anxieties about possible drilling activity on the Barrier Reef and in the Sydney Basin.

3.32 Mr Barry Jones of APPEA sought to refute these concerns. He told the Committee in evidence that 'we have absolutely no interest of any kind in exploring the Great Barrier Reef World Heritage area'.²⁶ He emphasised that exploration in areas around the reef posed no threat:

The way the rules work in this country is that if the oil was found in an area where the currents - meaning moving water - and temperature conditions would lead to a drift potentially at any time into the Barrier Reef World Heritage area, the development would not be allowed.²⁷

3.33 APPEA also advised that it was more likely for gas to be discovered than oil, as Australia was 'gas prone'. Australian oils are also very light, similar to kerosene, and evaporate readily, unlike those portrayed in catastrophic oil spills in the northern hemisphere. Any risk to the reef or other areas is therefore low.

3.34 There was no evidence before the Committee to suggest—nor is there any reason to believe—that the bill would affect the Great Barrier Reef World Heritage Area or otherwise have any adverse environmental impact.

Effectiveness of the measure

3.35 As noted previously, Australia is regarded as a risky exploration proposition, particularly in relation to oil, the prospects for finding a commercial oil field being low. Further, there is global competition for the exploration dollar.

24 *Proof Committee Hansard*, 1 March 2005, p. E12.

25 *House Hansard*, 10 February 2005, p. 36.

26 *Proof Committee Hansard*, 1 March 2005, p. E11.

27 *Proof Committee Hansard*, 1 March 2005, p. E17.

3.36 Political, social and economic stability do weigh in Australia's favour when decisions are made about whether to invest in exploration, but it is clear that the fiscal environment (i.e: the taxation of profits) is a central issue. In *Exploring: Australia's future*, the House of Representatives Standing Committee on Industry and Resources noted that submissions and evidence had repeatedly identified taxation as 'one of the primary factors that affected the economic quality of petroleum development'. A number of major submissions to that committee rated Australia as unattractive for investment.²⁸

3.37 APPEA supported the proposed measure as a step in the right direction:

We need to recognize that exploration is a high risk business...The proposed PRRT change recognizes this risk, particularly in deep water. It recognizes that there are public benefits to be gained if exploration is successful and that market forces alone will not drive that investment.²⁹

3.38 However, APPEA echoed the concerns raised in the House of Representatives inquiry about the competition for capital, noting that other countries had already altered their fiscal regimes to make them more competitive:

I think we also need to recognize that there will be strong competition for exploration capital globally over the next decade... The world out there is a highly competitive market. Other countries such as Norway, the UK, the USA and New Zealand have already adjusted their fiscal systems to maintain their international investment competitiveness. In our view, Australia should do the same. This measure is one step along the way.³⁰

3.39 The projected cost of this incentive is modest, about \$17 million. This amount contrasts markedly with the sums spent by the industry every year on exploration. (see for example paragraph 3.25). The Committee sought information about whether the measure would have an effect on exploration activity.

3.40 When asked whether the measure would result in any new wells being drilled, Mr Barry Jones of APPEA was cautious. His view was that if there were no bids on any of the frontier licence areas in the first or second round, then 'you have an answer to your question'.³¹ However, he noted that there were two possible kinds of benefits that might result: a commercial benefit, if a discovery is made; and a knowledge benefit:

Every piece of seismic survey that we run adds to the public knowledge of what is available in that area...At present, nothing is happening in those areas, or very limited is occurring. The number of bids you get, the amount

28 Para 3.87, p. 40.

29 *Proof Committee Hansard*, 1 March 2005, p. E12.

30 *Proof Committee Hansard*, 1 March 2005, p. E13.

31 *Proof Committee Hansard*, 1 March 2005, p. E13.

of seismic activity and eventually whether a discovery is made will all be indicators.³²

3.41 Committee members questioned Treasury officers about whether other incentives for encouraging exploration had been considered, for example, exempting offshore greenfield discoveries in designated areas from PRRT. The officers responded that this was a policy issue, and would not be drawn on what advice had been provided to the Government.

3.42 Officers did, however, advise that the Ministerial Council on Mineral and Petroleum Resources has recently requested a study into the fiscal competitiveness of the environment that the resources sector faces. Officers advised that the study would examine the fiscal regimes applying to energy resources across Australia and whether these are impediments to attracting investment. The study is to report to the Ministerial Council in September, but it will be a decision for the Council as to whether the report is published.

A level playing field?

3.43 Renewable Energy Generators of Australia Limited (REGA), while acknowledging the need for further petroleum exploration, did not appear to support the measure. REGA's argument was that targeting funds to the petroleum industry in this way skewed the allocation of capital towards the petroleum industry. Representing REGA, Mr Simon Maher contended that:

The impact, therefore, of providing a 150 per cent deduction in relation to exploration expenditure makes it more likely that capital will be allocated to the provision of a fossil fuel future for Australia and therefore less likely that capital will be available for renewable energy research and development...It is at the margin where economic decisions are made. The move being contemplated provides encouragement to fossil fuels but leaves a competing set of technologies behind.³³

3.44 Mr Maher did not appear to be aware of the relatively modest size of the proposal, conceding that the \$17 million allocated was not a substantial incentive within the renewable sector either. However, he maintained that the principle stood and that the effect, while marginal, would still be to change capital allocation incentives³⁴.

3.45 In this vein, the Committee explored the issue of whether there should be a uniform approach to taxation across the entire energy sector, including renewables. The Committee noted that coal resources are not subject to similar taxes. There are

32 *Proof Committee Hansard*, 1 March 2005, p. E18.

33 *Proof Committee Hansard*, 1 March 2005, p. E20.

34 *Proof Committee Hansard*, 1 March 2005, pp. E21-2.

obstacles to such a system, for example the Commonwealth has only offshore jurisdiction in this area, which is why PRRT does not apply to onshore oil and gas.

3.46 Mr Jones of APPEA considered a uniform approach to be a reasonable proposition:

In my view, it is a perfectly valid economic argument to consider the nature of resource taxation across this country and consider having a level playing field across all energy resources...

If the decision is that there should be some sort of resource use tax—which is the case, both for mining and petroleum—and if this resource tax is based on the grounds that these are public resources, community resources, being used by industry for a commercial reason and a public benefit, then I have two views: it should be a level playing field for everyone—and that does not exist, even within the fossil fuels sector—and it should cover everyone.³⁵

3.47 In supporting the concept of a level playing field within the resource sector, Mr Jones went on to say that even within the petroleum sector, APPEA did not consider that PRRT worked optimally:

I do not believe that it in fact treats risk within the petroleum sector in a consistent way. So I do not believe there is a level playing field within it.³⁶

3.48 When questioned about whether the renewables sector should pay a resource rent tax, Mr Maher of REGA acknowledged that there currently was no level playing field, but other factors had to be considered:

It depends what you contemplate as being the various issues of the relative sectors' impact on the economy. For example, the renewable sector certainly does not pay a resource rent tax. But on the other hand, the argument would be that it does not contribute to the same range of negative externalities that some other sectors of the economy do—in this case, fossil fuel. There is no level playing field, but I guess you take my point: certainly we accept that we do not get resource rent tax but neither do we provide detrimental impacts in certain aspects.³⁷

3.49 The Committee attempted to pursue this issue further with representatives of the Treasury and the Department of Industry, Tourism and Resources. Officers would not be drawn beyond observing that the whole issue of energy taxation is one where there are competing interests and views, and that the government has dealt with these, insofar as it is currently disposed to deal with them, in the energy white paper.

35 *Proof Committee Hansard*, 1 March 2005, p. E19.

36 *Proof Committee Hansard*, 1 March 2005, p. E19.

37 *Proof Committee Hansard*, 1 March 2005, p. E20.

Conclusions and recommendations

3.50 The Committee notes concerns about Australia's increasing dependence on imported oil and the level of international competition that exists for exploration funding. This is an important issue, which is under active consideration by government through the Ministerial Council on Mineral and Petroleum Resources' study of the fiscal competitiveness of the environment that the resources sector faces.

3.51 What this study will address has yet to be determined. The Committee is of the view that there is a persuasive case for considering the differential taxation treatment within sectors of the industry as well as factors that affect international competitiveness. Given that taxes applicable to the resources sector are cross-jurisdictional (i.e: the states having jurisdiction over land-based resources industries), the vehicle of a ministerial council study provides an appropriate means of addressing these issues. The Committee suggests that the Ministerial Council consider including these issues within the study.

3.52 On the basis of the evidence presented to it, the Committee does not consider that passage of the schedule will, in any way, heighten risks to the environment. Arguments to that effect are unsustainable, and the schedule should not be opposed on those grounds.

3.53 The Committee notes that the measure in this bill is relatively modest. However, it should not be viewed in isolation. It is actually part of a suite of initiatives, current and future, that are required to address the issue of Australia's future energy supplies. In particular, the Government's white paper, *Securing Australia's energy future*, provides a comprehensive of the Government's initiatives in this area. These include significant support for renewable energy programs.

Recommendation 1

3.54 The Committee recommends that the Government institute a public inquiry into the impact of differential tax regimes in the resources sector, in particular with a view to identifying and removing any anomalies arising from differential tax treatment within the sector.