Chapter 2

Reasons for removing the excise exemption

2.1 This chapter will outline the reasons for the measure to remove the excise exemption on condensate, support for the measure and related issues considered by the committee during the inquiry.

Changed environment and conditions

2.2 The Minister for Resources and Energy, the Hon. Martin Ferguson MP, explained that the original exemption of condensate was an encouragement to the development of petroleum resources as part of the North West Shelf project. The Minister stated that the exemption was no longer justified because the industry was now mature, profitable and oil prices were at record highs. Over the last five years $1.5 billion in profits had been returned to the companies, at oil prices half the current levels. A need had been served, and it was time to move on:

> ...I would have thought that our responsibility, having only brought on two LNG export opportunities in 20 years, is to actually devote our attention to the development of a modern 21st century program of incentives to encourage investment in new projects, rather than just continuing to substantially financially assist existing mature and highly profitable projects. I draw your attention to the fact that condensate excise exclusion was first introduced 24 years ago…[1]

2.3 Further to this, the Minister referred to the need to provide start-up incentives for new gas projects such as Gorgon, Browse, and Sunrise, which were struggling to get off the ground. There was a need to 'even up the playing field for investment'.[2]

2.4 Treasury officials told the committee that the condensate exemption was generally understood to be a measure which aimed to provide assistance to a developing industry and that:

> Contrary to suggestions from industry we have not been able to find any statements or documents which suggest that the exemption was supposed to apply indefinitely.[3]

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1 The Hon Martin Ferguson, Minister for Resources and Energy, *House of Representatives Hansard*, 17 June 2008, p. 61.

2 The Hon Martin Ferguson MP, Minister for Resources and Energy, *Media Release*, 14 May 2008.

3 Mr Paul McCullough, Acting General Manager, Revenue Group, Treasury, *Proof Committee Hansard*, 11 August 2008, p. E2.

Committee view

2.5 The committee noted the crude oil excise had been modified a number of times since it was introduced in the 1970s to take account of changing conditions. It accepted that adjustment to the condensate excise regime was justified because of changing conditions and the need to encourage new projects.

2.6 The committee noted, however, that the industry did not agree with this view. Industry argued that successive governments had assured the industry of a stable excise regime. That is, no change. Business decisions had been made on this basis. Industry concerns are covered in detail in chapter three.

Correction of a taxation anomaly

2.7 The government view was that the measure would correct a taxation anomaly in the North West Shelf Gas project area[4] and bring the project into line with conditions that prevailed for the rest of the industry. Both the Prime Minister and the Treasurer had argued that the tax advantage for the North West Shelf should be ended.[5] The Prime Minister explained to the House of Representatives that such a tax loophole could not be allowed to remain at a time when the financial integrity of the budget needed to be maintained.[6]

2.8 The Assistant Treasurer, the Hon. Chris Bowen MP, pointed out that the condensate exemption distorted the current tax regime as, given the similarity between condensate and crude oil, the two commodities should be taxed in a similar manner.[7]

2.9 This line of argument was supported by Dr Richard Griffiths who noted in his submission:

> …there is a strong case to be made for closing loopholes in the existing framework, so that this value capture can be effected efficiently and comprehensively. There is no strong argument for exemption other than the usual one – that no-one likes to be taxed.[8]

2.10 In responding to industry concerns regarding the change in the taxation regime, the Minister for Resources and Energy advised:

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4 The Hon Martin Ferguson MP, Minister for Resources and Energy, *Media Release*, 14 May 2008.

5 Andrew Probyn and Shane Wright, 'Tax on NW Shelf fair, says Swan', *West Australian*, 21 May 2008, p. 16.

6 The Hon Kevin Rudd MP, Prime Minister, *House of Representatives Hansard*, 27 May 2008, p. 3325.

7 The Hon Mr Chris Bowen, Assistant Treasurer, *House of Representatives Hansard*, 15 May 2008, p. 2878.

8 Dr Richard Griffiths, *Submission 1*, p. 1.

> We have to be frank – over time, taxation regimes do change – in fact governments have often responded to requests by industry to adjust taxation arrangements. Over the course of the last two decades, under both Labor and Coalition governments, Australian industry has benefited significantly from business tax reform.[9]

2.11 Mr Paul McCullough, from the Treasury Department's Revenue Group, told the committee that 'it remains the prerogative of any Australian parliament to change legislated tax arrangements' and noted that the North West shelf benefited from a change to the rates of excise applying to crude oil in 2001.[10]

Anticipating the Henry review

2.12 The committee heard evidence from industry witnesses about the hopes vested in a sympathetic attitude by the government's recently announced Henry review on taxation. The committee noted that the government had also anticipated some attention to this matter by the Henry review. The Minister for Resources and Energy emphasised that the Henry review would include tax issues facing the gas sector:

> This review will include an assessment of the barriers to investment in large-scale downstream gas processing projects in Australia, the particular hurdles faced by remote gas developers, and consideration of the future policy framework for new sunrise industry investment in Australia's gas sector, including new LNG, Gas-to-Liquids, and domestic gas projects.[11]

2.13 The Minister further highlighted the Henry review would look at measures to provide a competitive framework to underpin the development of gas resources.[12]

2.14 Industry supported the inclusion of petroleum specific issues in the Henry Review[13] and at the Perth hearing Ms Belinda Robinson, Chief Executive, APPEA told the committee:

> We are aware that the government is embarking on an energy policy process. They are also embarking on the Henry review of taxation. Perhaps it is within those processes that we can better, more systematically and

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9 The Hon Martin Ferguson MP, Minister for Resources and Energy, *Speech to the South East Asia Australia Offshore Conference (SEAAOC)*, 17 July, 2008.

10 Mr Paul McCullough, Acting General Manager. Revenue Group, Treasury, *Proof Senate Hansard*, 11 August 2008, p. E2.

11 The Hon Martin Ferguson MP, Minister for Resources and Energy, Speech to the South East Asia Australia Offshore Conference (SEAAOC), 17 July, 2008.

12 The Hon Martin Ferguson MP, Minister for Resources and Energy, *Media Release*, 14 May 2008.

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

> more coherently think about what it is that we are trying to achieve as a nation and take into account all the options for achieving that.[14]

2.15 Industry advocated that the Henry review look at the industry holistically in the context of energy security and industry potential and asked the review to specifically consider:

> …promoting the development of Australia's vast gas resources through measures such as company tax depreciation write-off periods, for the upstream production, transmission and processing of gas, being reduced to five years.[15]

2.16 Dr Griffiths commended the bill as a 'step in the right direction' but urged the government to undertake a comprehensive review and reform of the taxation regime for petroleum products for the following reasons:

1. the ongoing and permanent decline in total Australian oil production;
2. the historically high and still rising price of oil on the world market; and
3. the contribution made by the consumption of oil to anthropogenic climate change.[16]

Committee view

2.17 The committee noted the excise exemption is an anomaly which would be corrected by bringing it into line with the rest of the industry. The committee noted the potential of the gas industry to replace high carbon emitting fossil fuels while recognising that gas is a non-renewable form of energy.

2.18 The committee noted that gas industry is capital intensive because of the high costs of extraction. It understands that the Henry review will consider these circumstances in making its recommendations to government. The committee agrees that the taxation regime has an important bearing on the long term development of the industry. It urges the government to consider tax-related incentives apart from excise to encourage investment.

Recommendation 1

2.19 **The committee recommends that the government consider other incentives to assist the gas industry.**

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14 Ms Belinda Robinson, Chief Executive, APPEA, *Proof Committee Hansard*, 15 July 2008, p. E3.

15 North West Shelf Venture, *Submission 3*, p. 6.

16 Dr Richard Griffiths, *Submission 1*, p. 1.

Effect on future investment

2.20 Industry submissions stated that the excise exemption should be for the economic life of the project as the economics of gas projects were improved by the production of associated condensate.

2.21 Industry suggested that the measure would discourage future investment, and brought up the issue of sovereign risk as a concern. They argued that the policy change would affect the perception of risk for future investment for an industry which required large upfront capital investments and relied on long term planning and sales contracts. Industry views on this issue are detailed in chapter three.

Sovereign risk

2.22 Carolyn Vigar, Senor Associate, Minter Ellison defined sovereign risk as:

> …the risk of the state using its power to alter the established rights of private sector companies. It is a risk to private sector participants that a project's implementation may be hindered or prevented, or its operation adversely affected, because:
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> - agreements made, or assurances and undertakings given by a government are unenforceable;
> - a government exercises its powers selectively, imposing additional or different obligations on the project participants;
> - selective decisions or actions in government deprive the participants of ownership of or access to the resource, or limit the exportation of the resource; and
> - federal or state governments inconsistently exercise their respective constitutional powers.[17]

2.23 The submission from APPEA noted that sovereign risk was an important element in investment decisions by explorers and producers and:

> The decision has the potential to heighten the perception that large scale investment in Australia may be adversely affected by fundamental changes to the policy framework. While the incidence of the decision may appear on the surface to be limited to a relatively small number of entities, the negative impact such a decision has on the investment plans of global investors due to perceptions about policy adjustments should not be underestimated.[18]

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17 Carolyn Vigar, Senior Associate, Minter Ellison, 'Parrots, politics and policy: governmental risk in energy and resource projects', available at: http://www.minterellison.com/public/connect/Internet/Home/Legal+Insights/Newsletters/Previous+Newsletters/A-A-Parrots,+politics+and+policy, accessed 18 July 2008.

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

2.24 At the Senate estimates hearing on 2 June 2008, in response to a question from Senator Mathias Cormann regarding whether the exemption was a negotiated fiscal arrangement, Mr John Hartwell from the Department of Resources, Energy and Tourism told the committee:

> …it was not a negotiated agreement as such; it was a decision by the government at that time to provide an exemption for condensate.[19]

2.25 As noted by Mr Charles Berger, Director of Strategic Ideas to the Australian Conservation Foundation, the government had no contractual or legal obligation to maintain the exemption.[20]

2.26 Mr Berger further emphasised that business could not expect laws would always stay the same:

> …It is the role of governments to pass new laws and change regulatory regimes in response to new developments. Regulatory changes can be beneficial or detrimental to particular businesses. We accept this as one of many uncertainties that are simply part of doing business.[21]

2.27 The Minister for Resources and Energy stressed this issue in his speech at the South East Asia Australia Offshore Conference (SEAAOC) in July 2008 and emphasised that taxation regimes changed in response to new circumstances and business had benefited significantly from tax reform under Labor and Coalition governments.[22]

2.28 When asked about the effect of the measure on future investment, the Treasurer, the Hon. Mr Wayne Swan MP, told the media that he did not believe that it would have any effect on investment decisions.[23]

2.29 In statements to the media the Premier of Western Australia, Mr Alan Carpenter, rejected claims that the measure might compromise investment in the state:

> …they've been beneficiaries of the tax exemption it's up to them I suppose to respond as to what impact that will have on their bottom line and operations. But if you look around the world at the energy market the

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19 Mr John Hartwell, Head of Resources Division, Department of Resources, Energy and Tourism, Senate Economics Committee *Estimates Hansard*, 2 June 2008, p. E70.

20 Charles Berger, 'The sovereign risk furphy', Online Opinion, available at: http://www.onlineopinion.com.au/view.asp?article=7490&page=1, accessed 15 July 2008.

21 Charles Berger, 'The sovereign risk furphy', Online Opinion, available at: http://www.onlineopinion.com.au/view.asp?article=7490&page=1, accessed 15 July 2008.

22 The Hon Martin Ferguson MP, Minister for Resources and Energy, *Speech to the South East Asia Australia Offshore Conference (SEAAOC)*, 17 July, 2008.

23 Andrew Probyn and Shane Wright, 'Tax on NW Shelf fair, says Swan', *West Australian*, 21 May 2008, p. 16.

> energy needs the price increases I'd be very surprised [if] it has any impact on their operations.[24]

2.30 The Premier argued that the legislation would not discourage investment, and pointed out:

> People are knocking the door down to get into Western Australia. I don't think this relatively minor change which applies only to condensate which is a by-product as part of the LNG gas process will have any impact.[25]

2.31 Regarding investment confidence, Dr Griffiths told the committee:

> The inclusion of an investment confidence angle in the inquiry's remit implies a background assumption that increases in taxation are likely to reduce investment confidence. In a low-cost energy environment this may be the case. However, in the higher energy cost environment that we have now entered, investors are keen to identify opportunities to support 'oil proof' industries and regions – those that can weather energy price spikes intact, and even derive competitive advantage from higher prices.[26]

2.32 Mr McCullough from Treasury pointed out to the committee that:

> …it may be a little ambitious to suggest that the removal of an exemption that the government decided was no longer justified would have a direct impact in terms of sovereign risk for new projects falling under the PRRT [Petroleum Resource Rent Tax] arrangements.[27]

Committee view

2.33 The committee noted industry views on sovereign risk, but believes that the government's decision to impose an excise scarcely constitutes a threat to either markets or investment. It has never been the practice of any government in Australia to 'consult' industry sectors before imposing a tax or excise on their production. Such decisions are for governments alone. See chapter three for further industry views on this issue.

Community benefit

2.34 The government stated that the measure would allow the community a larger share in the benefits from the extraction of non-renewable energy resources in the

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24 ABC News 'We weren't consulted on Budget changes: petroleum industry', available at: http://www.abc.net.au/news/stories/2008/05/14/2244387.htm, accessed on 23 June 2008.

25 ABC News 'We weren't consulted on Budget changes: petroleum industry', available at: http://www.abc.net.au/news/stories/2008/05/14/2244387.htm, accessed on 23 June 2008.

26 Dr Richard Griffiths, *Submission 1*, p. 2.

27 Mr Paul McCullough, Acting General Manager, Revenue Group, Treasury, *Proof Senate Hansard*, 11 August 2008, p. E3.

North West Shelf area by a private company.[28] As the Prime Minister explained to the House of Representatives:

> …I have a simple response: let's use that revenue to assist families under pressure; let's use that revenue to start doing something about investing in the schools of Western Australia; let's use that revenue to invest in the hospitals of Western Australia; let's close a tax loophole that in fact can deliver revenue to the overall integrity also of the budget…. [29]

2.35 The Minister for Resources and Energy also pointed out:

> So far as I am concerned, we are about making sure that, in the national interest, the Australian community receives a fair share of benefits associated with Australia's resource development.[30]

Committee view

2.36 The committee agreed with the government's position in this regard.

Industry profits

2.37 While producers were strongly opposed to the measure because of the effect on overall profits, a look at their annual finances showed they were not struggling to stay afloat. Woodside Petroleum described 2006 as a record year with respect to production, profit, revenue and dividends. High oil prices, combined with higher production, delivered Woodside a net profit after tax of $1.427 billion, an increase of 29 per cent on 2005. Revenue in 2006 was $3.81 billion, up 39 per cent on the previous year, and net operating cash flow totalled $2.349 billion, or 37 per cent higher than 2005.[31] While profits were slightly lower in 2007, Woodside still managed to achieve a net profit of $1.03 billion.[32] Revenue in 2007 was $4.004 billion which was a five per cent increase from 2006 due to higher production and commodity prices.[33] On 17 July 2008 Woodside reported that for the second quarter for the period

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28 Excise Tariff Amendment (Condensate) Bill 2008, *Second Reading Speech.*

29 The Hon Kevin Rudd MP, Prime Minister, *House of Representatives Hansard*, 27 May 2008, p. 3325.

30 The Hon Martin Ferguson, Minister for Resources and Energy, *House of Representatives Hansard*, 17 June 2008, p. 61.

31 Woodside Petroleum Ltd, *36th Annual AGM Address*, 19 April 2007, available at: http://www.woodside.com.au/NR/rdonlyres/D8FB9B89-0F4F-4AE3-994E-B68A7CD7312A/0/2007AGMaddressbyChairmanandMDCEO.pdf, accessed 1 July 2008.

32 Woodside Petroleum Ltd, *37th Annual AGM Address*, 1 May 2008, available at: http://www.woodside.com.au/NR/rdonlyres/E81114CF-9A28-4CE9-B1B9-8F13C872E9F6/0/2008AGMAddressbyChairmanandMDCEO.pdf, accessed 1 July 2008.

33 'Woodside reports net profit of A$1,030 million', *ASX Announcement*, 20 February 2008, available at: http://www.woodside.com.au/NR/rdonlyres/9A85B477-A19C-471E-A5FD-B38D3DA29E8D/0/WoodsidereportsnetprofitofofA1030million.pdf, accessed 28 July 2008.

ended 30 June 2008, revenue was up 52 per cent over the corresponding quarter last year, due to higher commodity prices and additional production.[34]

2.38 It was recently announced that the year end share price as at 30 June 2008 for Woodside Petroleum was $67.50, an increase over the previous 12 months of 47 per cent. The year end share price as at 30 June 2008 for BHP Billiton was $43.70, an increase over the previous 12 months of 24 per cent.[35] This suggested that producers and their shareholders were reaping a substantial benefit from oil and gas production.

2.39 Dr Griffiths noted:

> In a situation of steeply rising petroleum prices worldwide, it is unlikely that increased excise will do much to dampen the profitability of oil and gas production.[36]

2.40 The Minister for Resources and Energy pointed out that in addition to the current returns to the North West Shelf Gas participants, they would continue to benefit from the 2001 reduction in the top rate of crude oil excise.[37]

> I might also say that this [return] is over and above an unintended windfall gain as a result of a concession introduced in 2001 to reduce the top rate of the crude oil excise. On my calculations, that has delivered to these participating companies another benefit of $1 billion since 2001.[38]

2.41 The media noted that the measure gave the North West Shelf Venture equal treatment to other crude oil producers and only took back about 40 per cent of the profits generated by the increase in oil prices in the past year.[39]

Committee view

2.42 Industry argued (see chapter three) that higher oil prices were substantially offset by increasing project development costs. The committee noted that despite increasing costs the industry continued to announce profits and participants appeared to be sufficiently diversified with other profitable projects. The committee also

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34 'Second quarter report for period ended 30 June 208', *ASX Announcement*, 17 July 2008, available at: http://www.woodside.com.au/NR/rdonlyres/BB046785-0D6C-4988-A67D-D413CE81790F/0/SecondQuarterReport.pdf, accessed 28 July 2008.

35 'Market Wrap 2007–08', *The Australian Financial Review*, 1 July 2008, p. S12.

36 Dr Richard Griffiths, *Submission 1*, p. 2.

37 As noted in the Bills Digest No. 114, the rates of excise on 'old oil' and 'new oil' were reduced on 1 July 2001 by the Excise Tariff Amendment (Crude Oil) Act 2001. The justification for the reductions was that the lower rates might stimulate further evaluation of the fields which were producing 'old oil' and 'new oil'.

38 The Hon Martin Ferguson, Minister for Resources and Energy, *House of Representatives Hansard*, 17 June 2008, p. 61.

39 Geoff Winestock, 'NW Shelf windfall to be taxed', *Australian Financial Review*, 14 May 2008, p. 12.

accepted that the current profitability of the oil and gas industry looked set to continue for the foreseeable future with the trend for rising oil prices.

Conclusion

2.43 The committee agreed that the exemption was granted to condensate when it was difficult for the partners in the venture to justify the costs of proceeding with the development. As was pointed out, the industry had since grown strongly, was mature, profitable, with growth expected to continue. The committee agreed with this assessment.

2.44 The committee also agreed that the exemption could be seen as a distortion in the tax regime and this argument was strengthened by the fact that condensate, sold co-mingled in a crude oil stream, was subject to excise. The committee supported the inclusion of tax issues facing the gas sector in the Henry review, noting that the taxation environment was important for investment and recommended the government consider measures to encourage investment in new projects.

2.45 The committee agreed with the government's position that the industry was liable for a tax on extraction of non-renewable energy resources for profit, and that a benefit should be returned to the community.

2.46 The next chapter will deal with the issues raised by industry during the inquiry and the committee's conclusions.