

The Senate

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Standing Committee on Economics

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Excise Legislation Amendment (Condensate)  
Bill 2008

Excise Tariff Amendment (Condensate)  
Bill 2008

August 2008

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# Membership of the Committee

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# Abbreviations

APPEA	Australian Petroleum Production and Exploration Association
ATO	Australian Taxation Office
BBL	Barrel (unit of measure for crude oil and petroleum products)
BOE	Barrel of oil equivalent
LNG	Liquefied natural gas
LPG	Liquefied petroleum gas
NWSV	North West Shelf Venture
PRRT	Petroleum Resource Rent Tax
VOLWARE	Volume-weighted average realised price
WA	Western Australia





# Chapter 1

## Excise Legislation Amendment (Condensate) Bill 2008 and Excise Tariff Amendment (Condensate) Bill 2008

### Reference

1.1 The Excise Legislation Amendment (Condensate) Bill 2008 and the Excise Tariff Amendment (Condensate) Bill 2008 were introduced into the House of Representatives on 15 May 2008. On 18 June 2008 the bills were referred to the Senate Economics Committee for report not before 26 August 2008, with particular reference to:

- (a) the impact of the changes on retail prices of domestic gas and electricity in Western Australia, and any consequent effect on consumer prices;
- (b) the impact of the decision on the industry generally and on the exploration for petroleum products in Australia; and
- (c) the impact of the decision, and the decision-making process, on domestic and international investment confidence in Australia.

1.2 The terms of reference also stated that the committee must conduct hearings in Western Australia and hear evidence from, inter alia, industry bodies and joint venture partners on the North West Shelf.

### Conduct of the inquiry and submissions

1.3 The committee advertised the inquiry on its website and in *The Australian* on 25 June 2008, calling for submissions by 7 July 2008. The committee also directly contacted a number of relevant organisations and individuals to notify them of the inquiry and to invite submissions and appearances before the committee. Three submissions were received as listed in Appendix 1. These appear on the committee's website.

1.4 The committee visited the North West Shelf Venture Karratha Gas Plant and Pluto LNG Project on 14 July 2008. Public hearings were held in Perth on 15 July 2008 and in Canberra on 11 August 2008. The witnesses are listed at Appendix 2.

### Acknowledgement

1.5 The committee thanks all those who contributed to its inquiry by preparing written submissions and giving evidence at the hearings.

## **Purpose of the bills**

1.6 The Excise Legislation Amendment (Condensate) Bill 2008, in conjunction with the Excise Tariff Amendment (Condensate) Bill 2008, remove the current exemption from excise of condensate produced in the North West Shelf project area and onshore areas. This measure was announced by the Treasurer on 13 May 2008<sup>1</sup> and applies to condensate produced from midnight on 13 May 2008.<sup>2</sup>

### **Excise Tariff Amendment (Condensate) Bill 2008**

#### ***Provisions of the bill***

1.7 The bill amends the *Excise Tariff Act 1921* to apply the crude oil excise regime to condensate produced in the North West Shelf project area and onshore Australia. This removes the current exemption of condensate from the crude oil regime.<sup>3</sup> It also introduces a new crude oil excise regime for production of condensate, equivalent to the regime applied to stabilised crude petroleum oil produced from petroleum fields discovered on or after 18 September 1975.<sup>4</sup>

1.8 The bill also makes amendments to ensure that production of condensate prior to the application of the bill (which is after midnight (by legal time in the Australian Capital Territory) on 13 May 2008) contributes to meeting the 4,767.3 megalitres (30 million barrels) threshold before the crude oil excise becomes payable.<sup>5</sup>

### **Excise Legislation Amendment (Condensate) Bill 2008**

#### ***Provisions of the bill***

1.9 The bill amends the *Excise Act 1901*, the *Petroleum Excise (Prices) Act 1987* and the *Petroleum Revenue Act 1985* to facilitate setting the condensate price for excise purposes.<sup>6</sup> These Acts are required to be read with the *Excise Tariff Act 1921*. The amendments made to the *Petroleum Excise (Prices) Act 1987* ensure the method for determining the price of condensate for calculating the crude oil excise payable in relation to the production of condensate is the same as the method for determining the price of stabilised crude petroleum oil. The amendments to the *Excise Act 1901* and the *Petroleum Revenue Act 1985* ensure consistency of the treatment of condensate with stabilised crude petroleum oil for the purposes of the crude oil excise.<sup>7</sup>

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1 *Budget Paper No.1*, 2008–09, pp 1–36.

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

3 *Revised Explanatory Memorandum*, p. 7.

4 *Revised Explanatory Memorandum*, p. 10.

5 *Revised Explanatory Memorandum*, pp 10–11.

6 *Revised Explanatory Memorandum*, p. 9.

7 *Revised Explanatory Memorandum*, p. 11.

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## Background

### *North West Shelf Venture project*

1.10 The North West Shelf Venture (NWSV) is Australia's largest resource and infrastructure project with capital expenditure over almost three decades totalling \$25 billion and with currently more than \$10 billion in further capital investment either committed or under consideration. In 2007, the project accounted for 48 per cent of Australia's petroleum production (54 per cent of natural gas production and 39 per cent of oil, condensate and liquefied petroleum gas (LPG) production) and total indicative sales of approximately \$11 billion.<sup>8</sup>

1.11 Based on huge gas and condensate fields on the North West Shelf of Western Australia, the Venture supplies natural gas to the domestic market in Western Australia, liquefied natural gas (LNG) to Japan and condensate, crude oil and LPG to other foreign markets. The NWSV comprises six multi-national companies, with each participant holding an equal share in future gas sales, subject to various joint venture arrangements. The participants are BP Developments Australia Ltd, Chevron Australia Pty Ltd, Japan Australia LNG (MIMI) Pty Ltd, Shell Development (Australia) Ltd, BHP Petroleum (North West Shelf) Pty Ltd, and Woodside Energy Ltd. Woodside is the operator of the project. Japan Australia LNG (MIMI) Pty Ltd is an investment vehicle of Mitsui and Mitsubishi.<sup>9</sup>

### *What is condensate?*

1.12 Natural gas comes from three types of wells: oil wells, gas wells, and condensate wells. Natural gas that comes from oil wells is typically termed 'associated gas'. This gas can exist separate from oil in the formation (free gas), or dissolved in the crude oil (dissolved gas). Natural gas from gas and condensate wells, in which there is little or no crude oil, is termed 'nonassociated gas'. Gas wells typically produce raw natural gas by itself, while condensate wells produce free natural gas along with a semi-liquid hydrocarbon condensate.<sup>10</sup>

1.13 Condensate is a light crude oil extracted from so-called 'wet' gas, and is processed mainly to produce petrol. While some crude oil, technically called 'stabilised crude petroleum oil', is subject to excise, condensate has since the 1977–78 Commonwealth budget been excise-free.<sup>11</sup>

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8 North West Shelf Venture, *Submission 3*, p. 3.

9 Information available at: <http://www.nwsg.com.au/sp-frameset.html?about/index.html>, accessed on 25 June 2008.

10 Natural Gas.Org website, *Processing Natural Gas*, [http://www.naturalgas.org/naturalgas/processing\\_ng.asp](http://www.naturalgas.org/naturalgas/processing_ng.asp), accessed 30 June 2008.

11 Richard Webb, 'Excise Legislation Amendment (Condensate) Bill 2008', *Bills Digest No. 115*, 2007–08, Parliamentary Library, Canberra, Australia, 27 May 2008, p. 2.

### *Crude oil excise*

1.14 Condensate is currently exempt from the crude oil excise. This exemption was introduced in 1977 to encourage the development of the LNG industry in the North West Shelf.<sup>12</sup>

1.15 The Excise Legislation Amendment (Condensate) Bill 2008, in conjunction with the Excise Tariff Amendment (Condensate) Bill 2008 ends the current exemption from excise of condensate produced in the North West Shelf project area and onshore areas, and applies the crude oil excise regime to condensate at the rates currently applied to crude oil produced from fields discovered after 18 September 1975.

1.16 Under these arrangements the top crude oil excise rate, which applies once annual production reaches just over five million barrels in a year, is 30 per cent.<sup>13</sup> Currently, the first 30 million barrels of crude oil produced from a field is exempt from crude oil excise.<sup>14</sup>

1.17 The bills introduce provisions to exempt from excise the first 30 million barrels of condensate produced from a field. Production of condensate from a petroleum field prior to midnight on 13 May 2008 will contribute towards meeting this threshold before the crude oil excise becomes payable.<sup>15</sup>

1.18 The Whitlam government introduced the crude oil excise in August 1975 to redistribute to the community, via the government, some of the gains oil producers received after world prices increased in 1973. In determining the level of excise, the then government sought to balance the return to the community against the need to ensure adequate incentives for exploration and production of oil. This was evident in the major changes to the excise rates which occurred on 23 October 1984.

1.19 Before this change, the rates depended on whether oil was classified as 'old' or 'new'. Oil discovered before 18 September 1975 was classified as 'old oil' and 'new oil' was oil produced from naturally occurring discrete accumulations discovered on or after 18 September 1975. The purpose of the excise revisions of 23 October 1984 was to encourage the development of a number of old oilfields that had not been developed due to inadequate returns under the previous oil excise scale. Under a new 'intermediate' excise category, such oilfields became eligible for concessional treatment. The exemption of condensate from excise was introduced in 1977 in the context of international oil prices exceeding domestic prices.<sup>16</sup>

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12 Richard Webb, Excise Legislation Amendment (Condensate) Bill 2008, *Bills Digest No. 115*, 2007–08, Parliamentary Library, Canberra, Australia, 27 May 2008, p. 2.

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

14 Excise Tariff Amendment (Condensate) Bill 2008, *Revised Explanatory Memorandum*, p. 9.

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

16 Richard Webb, 'Excise Tariff Amendment (Condensate) Bill 2008', *Bills Digest No. 114*, 2007–08, Parliamentary Library, Canberra, Australia, 27 May 2008, p. 2.

### *Value of sales*

1.20 The value of sales is known as VOLWARE (the volume-weighted average realised price). The rates of excise are:

- set as a percentage of VOLWARE;
- rise as the annual sales volume increases; and
- vary depending in whether the oil is old, new or intermediate.<sup>17</sup>

1.21 The current rates on new oil are set out in the following table<sup>18</sup> and these are the rates the bill proposes to apply to condensate.

<b>Annual sales (megalitres)</b>	<b>Percent of VOLWARE</b>
0 to 500	0
Over 500 to 600	10
Over 600 to 700	15
Over 700 to 800	20
Over 800	30

### *Compensation for reduction in royalties*

1.22 Establishing an excise on condensate will result in reduced royalties payable to the Western Australia (WA) government because crude oil excise payments are a deductible expense for calculating the offshore petroleum royalty. The Commonwealth government has committed to providing compensation to the WA government of \$80 million for reduced revenue in 2007–08, with payments in future years adjusted to equal the loss resulting from removing the condensate exemption on royalty payments to WA.<sup>19</sup> After accounting for these compensation payments, the Commonwealth government is expecting to receive a continuing net revenue gain of \$2.5 billion over the five year period from 2007–08 to 2011–12.<sup>20</sup>

### **Submissions and other evidence**

1.23 The committee received only a small number of submissions. The issues raised with the committee dealt mainly with the reasons for the measure with little

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17 Richard Webb, Excise Tariff Amendment (Condensate) Bill 2008, *Bills Digest No. 114*, 2007–08, Parliamentary Library, Canberra, Australia, 27 May 2008, p. 3.

18 Richard Webb, Excise Tariff Amendment (Condensate) Bill 2008, *Bills Digest No. 114*, 2007–08, Parliamentary Library, Canberra, Australia, 27 May 2008, p. 3.

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

20 Excise Tariff Amendment (Condensate) Bill 2008, *Revised Explanatory Memorandum*, p. 7.

reference to other provisions of the bills. This report therefore provides only a short description of the provisions, with terms of reference covered in chapters two and three. Chapter two outlines the reasons given for the introduction of the bill and support. Chapter three investigates the issues raised by industry and draws conclusions.

## 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...<sup>1</sup>

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'.<sup>2</sup>

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.<sup>3</sup>

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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<sup>4</sup> 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.<sup>5</sup> 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.<sup>6</sup>

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.<sup>7</sup>

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.<sup>8</sup>

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.



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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.<sup>9</sup>

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.<sup>10</sup>

### **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.<sup>11</sup>

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.<sup>12</sup>

2.14 Industry supported the inclusion of petroleum specific issues in the Henry Review<sup>13</sup> 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.<sup>14</sup>

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.<sup>15</sup>

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.<sup>16</sup>

### *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.

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## 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, Senior 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:

- 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.<sup>17</sup>

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.<sup>18</sup>

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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.<sup>19</sup>

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.<sup>20</sup>

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.<sup>21</sup>

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.<sup>22</sup>

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.<sup>23</sup>

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.

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

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.<sup>25</sup>

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.<sup>26</sup>

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.<sup>27</sup>

### ***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.<sup>28</sup> 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....<sup>29</sup>

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.<sup>30</sup>

### *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.<sup>31</sup> While profits were slightly lower in 2007, Woodside still managed to achieve a net profit of \$1.03 billion.<sup>32</sup> Revenue in 2007 was \$4.004 billion which was a five per cent increase from 2006 due to higher production and commodity prices.<sup>33</sup> 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, *36<sup>th</sup> 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, *37<sup>th</sup> 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/WoodsidereportsnetprofitofA1030million.pdf>, accessed 28 July 2008.

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

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.<sup>35</sup> 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.<sup>36</sup>

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.<sup>37</sup>

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.<sup>38</sup>

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.<sup>39</sup>

### ***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 2008', *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.



# Chapter 3

## Issues raised during the inquiry

### Introduction

3.1 During the course of the inquiry the committee was made aware of issues raised by industry resulting from the lifting of the excise exemption on condensate. It was claimed that introducing the excise would reduce profits for condensate producers, with the potential to discourage investment in future North West Shelf Venture (NWSV) projects. It was also claimed that the decision to remove the exemption was made by the government without consulting industry, thereby undermining relations between government and industry. These and other issues raised during the inquiry are discussed in more detail below.

### Changed environment and conditions

3.2 Industry did not agree with the view that current levels of profitability justified the withdrawal of the excise exemption. This was still required to provide an incentive for continued investment. Industry contended that 'the exemption was part of a broader fiscal regime introduced in 1977 that was intended to last the economic life of the project' and that it had continued on that basis for over 30 years. The committee heard from NWSV industry that the exemption from the excise was regarded as a permanent feature of industry's financial agreement with government, and that it was regarded as 'a complete fiscal assurance'.<sup>1</sup>

3.3 During the hearings, Ms Eve Howell, Chief Executive Officer of the NWSV told the committee that, in 1977, as the project was being conceived, the Commonwealth government 'acknowledged the long term nature and difference of gas projects from oil projects'. The government then entered into a partnership of assurances with the NWSV participants which led to the stable fiscal regime that had remained in place for over 30 years, helping to 'establish Australia as one of the lowest sovereign risk nations'.<sup>2</sup>

3.4 NWSV impressed upon the committee that as more funding was committed by the participants, it had sought and received assurances from governments that a

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1 Ms Eve Howell, Chief Executive Officer, North West Shelf Venture, *Proof Committee Hansard*, 15 July 2008, p. E23.

2 Ms Eve Howell, Chief Executive Officer, North West Shelf Venture, *Proof Committee Hansard*, 15 July 2008, p. E21.

stable fiscal regime would be maintained<sup>3</sup> and that changes would not be made to the fiscal arrangements without consultation.<sup>4</sup>

3.5 The NWSV submission posited that:

If the exemption was truly viewed as being a form of developing industry assistance, the government would have abolished it after 1992 once the originally envisaged domestic gas and three train LNG phases of the project had all become fully operational.<sup>5</sup>

3.6 The committee asked the NWSV to expand on claims in their submission, at paragraph 3.3 'developing industry assistance', that the concept of the exemption from condensate tax being regarded as a development assistance measure simply did not accord with the facts under which that exemption was set up. Ms Howell responded:

I think I have made the point already about a whole-of-life approach. I cannot say what the intentions were in 1977. I was not there. But to the best of my belief, I think that these assurances were put in place on the basis of a whole-of-life approach. Recognise that this is predominantly a gas project, so this was part of the total package. As I say, to the best of my knowledge there was no suggestion that this would be reviewed at a certain time based on the profitability or otherwise of the project.<sup>6</sup>

3.7 In further arguing against the government's case that the excise free status on condensate was an incentive for initial development of the project, APPEA pointed out that the subsequent amendments made to the excise regime in 1997 and 2001 gave no indication of any future intention of modifying the excise treatment of condensate production. APPEA argued:

Overall, the arrangement has provided an important stimulus for companies to explore for and make subsequent investment decisions to produce condensate that occurs in association with natural gas. In many cases, the production of condensate has provided the economic underpinning for gas projects especially in determining whether projects are to proceed.<sup>7</sup>

### **Effect on future investment**

3.8 As foreshadowed in chapter two, industry argued that lifting the excise exemption would create uncertainty for the project due to the change in a long standing fiscal regime which would threaten future investment.

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3 North West Shelf Venture, *Submission 3*, p. 4.

4 North West Shelf Venture, *Submission 3*, p. 3.

5 North West Shelf Venture, *Submission 3*, p. 4.

6 Ms Eve Howell, Chief Executive Officer, North West Shelf Venture, *Proof Committee Hansard*, 15 July 2008, p. E35.

7 APPEA, *Submission 2*, p. 7.

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## *Sovereign risk*

3.9 The NWSV submitted that the decision to change a longstanding fiscal regime without consultation and without a rigorous assessment of the key factors created a new element of sovereign risk not previously seen in the industry. They argued that gas projects were particularly sensitive to sovereign risk because:

- they were long term commitments;
- it took five or more years to plan and construct a multi-train greenfields LNG project;
- there were initial and continuing capital investment requirements for tens of billions of dollars – usually from offshore sources; and
- it could take a decade or more to earn a positive return on this capital investment, with positive life of project returns requiring even longer periods.<sup>8</sup>

3.10 APPEA argued that the overall perception of a particular country as a place to invest was 'critical in a range of important exploration and development decisions'. Ms Robinson told the committee:

We have always prided ourselves as a nation on being a country which is investor friendly. Although we are the highest cost destination for LNG investment supplying the Asia-Pacific region, we have a reputation for a low level of sovereign risk which counterbalances a range of other technical and geological challenges that disadvantages us relative to our competitors...the change will have an impact through signalling a willingness on the parts of governments to dramatically shift the fiscal terms after a project is up and running and contrary to agreed terms that form the basis of the project going forward on a lifecycle basis. This introduces an important new element in the suite of factors that an investor must consider in making project decisions.<sup>9</sup>

3.11 Industry advised the committee that when signing off on any fiscal project, it was done on the basis of the whole lifetime of that project, and that there was a long period, sometimes 10 or 12 years, until projects actually started to make money. 'Changing the goalposts along the way by definition neglects to take the full cycle of that project into account'.<sup>10</sup>

3.12 Sovereign risk issues were also raised by the NWSV. Ms Howell pointed out that Australia had been regarded as having very low sovereign risk, something that had attracted both Australian companies and international companies to invest in

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8 North West Shelf Venture, *Submission 3*, p. 3.

9 Ms Belinda Robinson, Chief Executive, APPEA, *Proof Committee Hansard*, 15 July 2008, pp E1–E2.

10 Ms Belinda Robinson, Chief Executive, APPEA, *Proof Committee Hansard*, 15 July 2008, p. E4.

Australia. The committee was told that NWSV would like to see overseas investor confidence restored and thought it was unfortunate that the decision might have created a 'little bit of a hiccup in terms of that belief'.<sup>11</sup>

3.13 NWSV called on the government to consult industry about the merits and means of introducing a formal bipartisan system of fiscal stability agreements to provide certainty to long life gas projects.<sup>12</sup>

### ***Future investment***

3.14 Industry argued that the change in the fiscal framework would undermine investor confidence and discourage future investment, as investment was sensitive to the taxation regimes applied in different countries.

3.15 As previously mentioned, APPEA told the committee that the existing arrangement had provided an important stimulus for companies to explore and make subsequent investment decisions to produce condensate that occurred in association with natural gas. In many cases, the production of condensate had provided the economic underpinning for gas projects and in determining whether projects were to proceed.<sup>13</sup> In order to illustrate the economics of gas projects Mr Noel Mullen from APPEA told the committee:

One of the interesting facts in Australia is that very few gas projects have proceeded without associated condensate production. The reason for that is that the condensate actually aids the economics of gas. What we call dry gas projects, which are projects that do not have associated liquids, invariably face significant challenges in terms of their economics. So any imposts which affect the overall economics of a project decision will feed through into the prices that participants or project developers require to make those projects economic...<sup>14</sup>

3.16 The point was made that future investment decisions for fields that have exceeded 30 million barrels for excise free production might be in doubt. Participants might then consider alternative investments if the project seemed unprofitable.<sup>15</sup>

3.17 The committee also noted evidence from APPEA that a number of companies had said they would require some type of fiscal agreement that they could show their

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11 Ms Eve Howell, Chief Executive Officer, North West Shelf Venture, *Proof Committee Hansard*, 15 July 2008, p. E36.

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

13 APPEA, *Submission 2*, p. 7.

14 Mr Noel Mullen, APPEA, *Proof Committee Hansard*, 15 July 2008, p. E11.

15 APPEA, *Submission 2*, p. 10.

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boards so that investors could be reassured that the 'goalposts' were not going to be changed half way through.<sup>16</sup>

3.18 Similarly, NWSV expressed concern that the effect of the bills had not been adequately considered for the long term nature of gas projects, the ongoing capital investment required and the length of time to achieve a positive return on the investment.<sup>17</sup>

### ***Encouragement for the gas industry***

3.19 Concern was expressed regarding the excise hindering future development in the industry. APPEA noted that the excise would create a further imbalance between the resource taxation applied to much of Australia's gas production compared with coal, at a time when more should be done to encourage gas exploration.<sup>18</sup> This was at a time when LNG could play a role in reducing global greenhouse emissions.<sup>19</sup>

3.20 APPEA was also concerned that the measure could affect whether the vast gas resources would be available to meet energy needs in Australia and the Asia-Pacific.<sup>20</sup>

3.21 APPEA advocated that one way to raise an additional \$2.5 billion of tax revenue would be to develop extra LNG projects. Every two new trains of LNG would deliver \$40 billion of tax revenue to the government over the life of the project. Finding ways to encourage and grow the industry was the 'key'.<sup>21</sup>

3.22 Mr Colin Brown, Acting General Manager, Tax Analysis Division, Treasury, told the committee they did not expect the measure to have any effect on exploration of other areas as the only major offshore area affected is the North West Shelf. He pointed out that other offshore areas are subject to the PRRT and this has not changed.<sup>22</sup>

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16 Ms Belinda Robinson, Chief Executive, APPEA, Proof Committee Hansard, 15 July 2008, p. E13.

17 Ms Eve Howell, Chief Executive Officer, North West Shelf Venture, *Proof Committee Hansard*, 15 July 2008, p. E21.

18 Information available at: <http://www.abc.net.au/news/stories/2008/05/14/2244387.htm>, accessed on 23 June 2008.

19 Ms Belinda Robinson, APPEA, *Proof Committee Hansard*, 15 July 2008, p. E12.

20 Ms Belinda Robinson, APPEA, *Proof Committee Hansard*, 15 July 2008, pp E7–8.

21 Ms Belinda Robinson, Chief Executive, Mr Noel Mullen, Deputy Chief Executive, APPEA, *Proof Committee Hansard*, 15 July 2008, p. E19.

22 Mr Colin Brown, Acting General Manager, Tax Analysis Division, Treasury, *Proof Committee Hansard*, p. E7.

### ***Lack of consultation***

3.23 Industry told the committee that the decision to remove the condensate exemption was announced without consultation with the affected companies or the wider industry and that this had undermined relations between government and industry, and had created uncertainty for investors.<sup>23</sup>

3.24 Industry stated that it was difficult to look at these projects in comparison to other ventures to see if the measure created a level playing field or not, as there had been no consultation with government. This made it difficult for industry to assess the measure or model its full effect. Ms Howell told the committee:

We would like to have the opportunity to engage with government and to engage with Treasury to work through these issues, which we believe should have been worked through before this announcement was made.<sup>24</sup>

3.25 The committee noted that the Prime Minister had addressed this issue and stated:

The government maintains a close working relationship with the mining sector and the resources sector in Australia. We have done so in the past; we will continue to do so in the future.<sup>25</sup>

### ***Wider policy implications***

3.26 It was argued that there was a need to recognise the role that LNG could play in reducing global greenhouse emissions and in energy security. Dr Richard Griffiths raised the question of how Australia was hedging against the inevitable decline of energy resources. Dr Griffiths spoke to the committee about the need for Australia to look to overseas experiences such as in Norway where the government established an oil taxation regime to hedge against declining energy resources in the medium to long term.<sup>26</sup>

3.27 The committee noted with disappointment that the Department of Resources, Energy and Tourism declined to provide a submission or appear before the committee and therefore there was no opportunity to discuss these broader questions. However, the committee noted the work underway by the department on the development of a White Paper on energy issues<sup>27</sup> and a National Energy Security Assessment.<sup>28</sup> The

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23 North West Shelf Venture, *Submission 3*, p. 3.

24 Ms Eve Howell, Chief Executive Officer, North West Shelf Venture, *Proof Committee Hansard*, 15 July 2008, pp E28–29.

25 Prime Minister, The Hon Kevin Rudd MP, *House of Representatives Hansard*, 26 May 2008, p. 3097.

26 Dr Richard Griffiths, *Proof Committee Hansard*, 11 August 2008, p. E9.

27 The White Paper was announced by the Prime Minister on 28 May 2008.

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committee supported the government's stated objectives of energy security and the reduction of fossil fuel related greenhouse emissions.<sup>29</sup>

### *Committee view*

3.28 Since these broader issues raised in evidence were not able to be addressed, especially in regard to the role of LNG in reducing global greenhouse emissions and energy security, the committee recommends that the government, as part of the work outlined above, clarify the role of the gas industry within broader energy security and climate change policies in order to provide more certainty for industry development and investment.

### **Recommendation 2**

**3.29 The committee recommends that the work being undertaken by the Department of Resources, Energy and Tourism to produce a White Paper and National Energy Security Assessment clarifies the role of the gas industry within broader energy security and climate change policies to provide greater certainty for future projects and investment.**

### **Effect on the community**

3.30 Industry representation argued that the increased administrative and compliance costs resulting from this measure could lead to increased gas prices.

### *Additional administrative costs*

3.31 APPEA pointed out that the producers of condensate would now face a range of compliance and verification obligations. APPEA particularly mentioned the need for producers to nominate 'prescribed condensate production areas' which formed the basis under the legislation for levying the excise on condensate production. They noted the Excise Tariff Amendment (Condensate) Bill 2008 applied a wide definition that gave a significant degree of discretion to the Australian Taxation Office (ATO). However the *Excise Tariff Act 1921* provided guidance on how this discretion should be exercised. They cautioned that similar principles in defining 'prescribed condensate production area' should apply as currently existed for crude oil production.<sup>30</sup>

3.32 Because the decision had a commencement date of budget night, APPEA argued that the complexity of the crude oil excise regime made such a decision very

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28 The assessment will identify key strategic energy security issues in the liquid fuels, natural gas and electricity sectors currently and those likely to influence the level of energy security in 5, 10 and 15 years. It will consider how the identified strategic issues could affect adequacy, reliability and affordability in each of the energy sectors.

29 Available at: <http://www.ret.gov.au/energy/facts/Pages/EnergyWhitePaper.aspx> and [http://www.ret.gov.au/energy/energy\\_security/national\\_energy\\_security\\_assessment/Pages/NationalEnergySecurityAssessment.aspx](http://www.ret.gov.au/energy/energy_security/national_energy_security_assessment/Pages/NationalEnergySecurityAssessment.aspx), accessed on 31 July 2008.

30 APPEA, *Submission 2*, pp 8–9.

difficult to implement. The number of offshore and onshore petroleum fields covered by the decision made the technical processes of identifying, verifying and auditing historical production extremely challenging, assuming information actually even existed. Despite the industry now being subject to a \$2.5 billion excise, APPEA had been working collaboratively with the ATO to streamline the process. APPEA pointed out that these processes would require much time to implement.

3.33 On top of this, it was highly unlikely that existing onshore discoveries of condensate would ever incur an excise liability. However, onshore producers still needed to comply with implementation and reporting obligations under the regime.<sup>31</sup> APPEA argued that the potential excise liability on onshore condensate production in the event of a future discovery might discourage future exploration.<sup>32</sup>

3.34 Mr McCullough from Treasury responded to this issue at the Canberra hearing by explaining that the compliance costs and requirements would be minimised as far as possible for those temporarily not subject to the regime.<sup>33</sup>

### *Domestic gas prices*

3.35 Concerns were expressed that additional administrative and compliance costs incurred by the industry would be passed on to consumers through higher gas prices.

3.36 APPEA cautioned that where excise was payable, gas producers might now require higher prices on gas sales to underpin or support project economics.<sup>34</sup> Ms Howell of NWSV told the committee that future contracts would have to offset these additional costs,<sup>35</sup> including whether or not these costs should be passed on to consumers. Costs might not be recouped by industry for existing contracts.<sup>36</sup>

3.37 As Ms Robinson from APPEA explained:

...I think that is a really important thing to remember with the gas industry; they are subject to long-term contracts. Some of them are not particularly favourable, but they were signed off at a particular time that you wear. So

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31 Ms Belinda Robinson, Chief Executive, APPEA, *Proof Committee Hansard*, 15 July 2008, p. E2 and Mr Noel Mullen, Deputy Chief Executive, APPEA, *Proof Committee Hansard*, 15 July 2008, pp E9–E10.

32 APPEA *Submission 2*, pp 9–10.

33 Mr Paul McCullough, Acting General Manager. Revenue Group, Treasury, *Proof Senate Hansard*, 11 August 2008, p. E5.

34 APPEA, *Submission 2*, p. 11.

35 Ms Eve Howell, Chief Executive Officer, North West Shelf Venture, *Proof Committee Hansard*, 15 July 2008, p. E26.

36 Ms Eve Howell, Chief Executive Officer, North West Shelf Venture, *Proof Committee Hansard*, 15 July 2008, p. E34.



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the options really are to take it on the chin, take it off your bottom line or to pass it through in your future contracts—so from here on in...<sup>37</sup>

3.38 The media reported that at Woodside's recent annual general meeting, shareholders expressed concern that the company was focussed on lucrative exports instead of domestic natural gas supply. The company responded that while it needed to capitalise on the current high LNG prices, it would reserve 15 per cent of LNG from its Pluto development for domestic purposes under the WA government's gas reservation policy<sup>38, 39</sup>. Dr Griffiths suggested to the committee that the Western Australian approach could be used elsewhere to provide Australia with some degree of fuel security.<sup>40</sup>

3.39 When asked at the Perth hearing about the price of domestic gas, Ms Howell told the committee:

What I can say is that our current domestic contracts are in place and will be honoured. We in general have no ability to pass on this additional impost. However, this will be one of a number of factors that are currently impacting domestic gas prices, including the supply-demand balance.<sup>41</sup>

3.40 Mr Brown from Treasury responded to questions on this issue by stating that there would be no affect on domestic gas prices as these were set by international markets.<sup>42</sup> Responding to additional questions he provided further explanation to the committee:

...in terms of WA gas prices, there are probably two things regarding the types of gas that are used. Liquid petroleum gas, which is one form of gas that is used there, is priced in WA by reference to a world price for liquid petroleum gas – as it is in the rest of Australia. In the case of natural gas supplied to small use customers in Western Australia that is subject to

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37 Ms Belinda Robinson, APPEA, *Proof Committee Hansard*, 15 July 2008, p. E8.

38 Western Australia released its domestic gas reservation policy statement in October 2006. It aims to ensure adequate access to domestic gas supplies. The equivalent of 15 per cent of LNG production from export gas projects is required to be reserved for domestic use as a condition of access to WA land for the location of processing facilities. The target of 15 per cent reflects current estimates of future gas needs, estimated gas reserves and forecast LNG production and will be subject to periodic review. Available at: <http://www.hawkerbritton.com/hawker-britton-media/public-affairs/western-australia-domestic-gas-policy.htm> accessed 21 July 2008.

39 'Condensate Exemption hits Woodside hard', *Sydney Morning Herald*, available at: <http://news.smh.com.au/business/condensate-exemption-hits-woodside-hard-20080514-2e21.html>, accessed 21 July 2008.

40 Dr Richard Griffiths, *Proof Committee Hansard*, 11 August 2008, p. E15.

41 Ms Eve Howell, Chief Executive Officer, North West Shelf Venture, *Proof Committee Hansard*, 15 July 2008, p. E27.

42 Mr Colin Brown, Acting General Manager, Tax Analysis Division, Treasury, *Proof Committee Hansard*, 11 August 2008, p. E3.

regulation by the Western Australian government under the energy coordination gas tariff regulations.<sup>43</sup>

### ***Effect on the price of petrol***

3.41 The question of whether the measure would affect the price of petrol was also raised. The government explained that the measure would not have any effect on the price of petrol as this was set by international markets which make Australia a 'price taker'.<sup>44</sup>

### ***Committee view***

3.42 The committee noted the inclusion of a 60 day registration/compliance period to assist the compliance and verification process.

3.43 The committee noted the concerns about the effect of the measure on the price of domestic gas but received no conclusive evidence from the industry that this would occur. Treasury officials reassured the committee that they did not expect any effect.

### **Industry profits**

3.44 One of the concerns raised by industry during the inquiry was the perception that industry was making huge profits, and that this was the driver for the implementation of the measure. APPEA highlighted the issue, and told the committee that this misconception was due to a failure to recognise the long lead times in the gas industry, contracts that lock in prices, high capital costs and delayed profitability.<sup>45</sup>

3.45 APPEA noted in their submission that the government had failed to recognise that the strength in commodity prices had coincided with a period of rapid cost growth for the industry in exploration expenditure over the last three years which was constraining growth in profits.<sup>46</sup>

3.46 NWSV noted that the headline oil price did not flow on to companies on a proportionate basis for these reasons:

- oil and gas project costs have doubled over the past five years and would continue to escalate due to broader economic issues affecting the oil and gas industry and as participants pursued the exploration and development of more remote gas reserves;

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43 Mr Colin Brown, Acting General Manager, Tax Analysis Division, Treasury, *Proof Committee Hansard*, 11 August 2008, p. E7.

44 The Hon Chris Bowen, Assistant Treasurer, *House of Representatives Hansard*, 15 May 2008, p. 2880.

45 Ms Belinda Robinson, Chief Executive, APPEA, *Proof Committee Hansard*, 15 July 2008, pp E7–E8.

46 APPEA, *Submission 2*, pp 11–13.

- much of gas production was sold locally, or if exported, was sold under long term contracts with prices not totally linked to global oil and gas prices; and
- the rise in the Australian dollar had offset a material part of the rise in US dollar denominated oil and export gas prices.<sup>47</sup>

3.47 NWSV concluded that the combined effect of an appreciating Australian dollar and low-priced gas contracts was that the average realised price per barrel-of-oil-equivalent (boe) of oil and gas production in Australia increased by just 36 per cent over the five years to 2006–07. This was compared with a near trebling of world oil prices (from \$US21.59 per barrel (bbl) in 2001–02 to \$US59.45 per bbl in 2006–07 in trade weighted terms).<sup>48</sup>

3.48 As Ms Robinson pointed out, while there had been a well-documented oil price rise, industry was becoming worried about the view that this simply translated into higher returns or windfall profits which was not the case. Much higher costs had eroded returns on investment, the industry faced the same challenges that confronted the rest of the resources sector and that spiralling costs constrained exploration and development budgets.<sup>49</sup> Ms Robinson stated:

The increase in tax revenue is a consequence of the increase in the price of oil, which is how the taxes are calculated. That is why we are seeing the increase in the revenue; it is because of the increase in the value of the oil. So, the higher the price of oil, the more tax revenue is generated back to government. That has nothing to do with company profits.<sup>50</sup>

### *Committee view*

3.49 The committee noted the view in chapter two that, despite increasing costs, the industry continued to announce profits and joint venture partners' larger earnings bases would lessen the proportional effect on profits. The committee also accepted that the current profitability of the oil and gas industry looked set to continue for the foreseeable future with rising oil prices. It also recognised that industry profitability had been affected by the low prices for LNG negotiated in early contracts. The committee could make no comment on past negotiations, but made the point that company profitability was far more dependent on markets and negotiation of sales than on obligations to pay excise.

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47 North West Shelf Venture, *Submission 3*, p. 5.

48 North West Shelf Venture, *Submission 3*, p. 5.

49 Ms Belinda Robinson, Chief Executive, APPEA, *Proof Committee Hansard*, 15 July 2008, p. E2.

50 Ms Belinda Robinson, Chief Executive, APPEA, *Proof Committee Hansard*, 15 July 2008, p. E14.

## Conclusions

3.50 The committee agreed with the main argument from the government that rather than assisting mature and profitable projects, it was time to reassess incentives to encourage investment in new projects. The committee noted the new gas projects mentioned by the Minister for Energy and Resources such as Gorgon, Browse and Sunrise and agreed that encouraging investment in new projects should be the priority.

3.51 The committee agreed that taxation regimes needed to change to take account of changing environment and conditions. 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 and accepted that an adjustment to the condensate excise as a result of changing conditions and to encourage new projects was also warranted.

3.52 The government's announcement that the Henry review would include tax issues facing the gas sector was supported by the committee. The committee agreed that the taxation regime is important for investment and long-term development of the industry. It recommends the government consider other incentives to encourage investment.

3.53 The committee noted industry views on sovereign risk, but believed that the government's decision to impose an excise scarcely constituted a threat to either markets or investment. The committee also noted that if the measure was believed to have a wider effect on the investment climate and investor confidence the committee would have expected to receive more submissions from a wider range of concerned parties.

3.54 Broader issues raised in evidence were not able to be addressed, especially in regard to the role of LNG in reducing global greenhouse emissions and energy security. The committee recommends the government address the role of the industry in the current work under way in the Department of Resources, Energy and Tourism on the development of a White Paper on energy issues and a National Energy Security Assessment to provide more certainty for industry development and investment.

3.55 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. The committee recognised that producers were concerned about the effects of this legislation upon shareholder returns and on their profit margins generally. However, such measures were bound to be unpopular with those from whom the revenue was raised. The committee considered that producers had enjoyed the benefits of the excise exemption for far too long, and in effect, the changes simply adjusted the condensate producers' profit margins to levels consistent with similar forms of production. It repeated its earlier comment that arguments about lack of consultation on the imposition of an excise were naïve. Governments did not consult those whom they tax beforehand for reasons too obvious to cite in this report.

3.56 Industry argued 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 joint venture partners' larger earnings bases would lessen the proportional reduction of profits. The committee also 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.

3.57 The committee noted the concerns about the effect of the measure on the price of domestic gas. The committee, however, did not receive conclusive evidence from the industry that this would occur.

3.58 After considering the evidence the committee believed the measure to lift the exemption from an excise on condensate is justified and supports the government's introduction of the relevant legislation.

### **Recommendation 3**

3.59 **The committee recommends that the bills be passed.**

**Senator Annette Hurley**

**Chair**



# COALITION SENATORS' DISSENTING REPORT

## Introduction

Coalition senators are deeply concerned that the future of Australia's gas industry, particularly the export-focussed and environmentally-beneficial LNG sector, is being threatened by an ill-conceived decision which is nothing more than a cynical revenue-raising exercise.

By imposing an excise on condensate from the North West Shelf (NWS), the Government intends to raise \$2.5 billion in additional revenue over the forward estimates period to help fund a \$15 billion increase in net government spending.

The way the measure has been introduced has the potential to seriously undermine investor confidence at a time when economically and environmentally we should be doing everything we can to attract more investment in gas exploration and production.

Major LNG projects, such as the Inpex Ichthys project and Woodside's Browse project, are key components of an expected \$100 billion worth of new projects in Australia's oil and gas sector.

While Australia has been touted as having the potential to be another Qatar, we remain "underweight" in terms of LNG projects.

With demand for LNG in the Pacific Basin expected to grow by 83 per cent by the end of the next decade, Australia needs to be making the right public policy decisions today aimed at encouraging investment in gas exploration and production.

These decisions can only be made if the government of the day sets down a clear, strategic framework which recognises the unique challenges faced by the LNG industry and provides investors with the confidence to commit the huge sums of money required over the long timeframes involved in developing LNG projects.

As the Australian Petroleum Production and Exploration Association (APPEA) put it, the government needs to decide whether it is going to plan for the industry's growth or if it is simply going to tax the industry to a point of paralysis.<sup>1</sup>

Coalition senators believe the government's decision to hit the industry with a new \$2.5 billion tax grab confirms the present government is prepared to put short-term revenue raising ahead of sound, long-term, strategic policy development.

The inclusion of taxation arrangements for the oil and gas industry in the terms of reference for the Henry Review confirms that the government has put the cart before the horse and has imposed this tax increase with no clear understanding of the ramifications.

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<sup>1</sup> Ms Belinda Robinson, Chief Executive, APPEA, *Proof Committee Hansard*, 15 July 2008, p. E13.

In summary, our major concerns, supported by the evidence presented to the committee, are that this new tax measure:

- is driven by a short term desire to raise revenue to pay for significant spending increases and not by a strategic direction balancing the objective of achieving an appropriate return to the community with the need to provide a competitive taxation framework for an important industry;
- undermines Australia's reputation for low sovereign risk;
- works against Australia's ability to attract new LNG investment;
- negatively affects new investment decisions for Australia's largest resources project;
- impacts significantly on the price competitiveness of LNG exporters;
- imposes significant compliance challenges and costs on the industry; and
- will inevitably lead to higher domestic gas prices in Western Australia for both industrial and residential users.

## **Background**

Coalition senators recognise the importance of the gas industry when it comes to ensuring our energy security, boosting our capacity to help address the challenge of climate change and helping drive our future prosperity as a nation.

According to APPEA, the oil and gas sector contributed an average of \$5billion a year in taxation revenue over the five years to 2006-07. The LNG sector is a key component of the industry and generated export sales worth \$5billion in 2006/07<sup>2</sup>.

The LNG industry also generates thousands of jobs, directly and indirectly, and has made an enormous contribution to the extraordinary economic growth experienced in Western Australia.

The cornerstone of Australia's LNG industry has been the massive North West Shelf (NWS) project; this new measure directly affects this project.

For 30 years the NWS project had enjoyed a stable fiscal framework, negotiated in good faith with the Commonwealth, which had helped underpin the largest capital investment in a resources project in Australia. These arrangements enjoyed bi-partisan support throughout the years from consecutive governments.

The move to remove the exemption for this project from the excise on condensate breaches that trust. It threatens future investment decisions within the venture and, as evidenced by APPEA, sends a dangerous message to foreign investors on sovereign risk.

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<sup>2</sup> Source: ABARE



It is almost beyond belief that a government would impose a new \$2.5 billion tax impost on such an economically vital industry without carefully thinking through the ramifications.

Evidence presented to the Committee confirmed that the Commonwealth had not consulted with the industry on the planned change, its implementation or its broader implications for the future growth of the gas industry.

This is surprising given the well-grounded speculation that this measure had been identified as a revenue-raising measure by the ALP while in Opposition in the lead-up to the 2007 Federal election.

In April 2008, the Minister for Resources and Energy, the Hon Martin Ferguson, told the APPEA national conference in Perth:

Open and transparent investment frameworks – underpinned by our democratic principles and commitment to strong governance arrangements – are the key to investment confidence in our nation.<sup>3</sup>

Mr Ferguson's commitment to transparency did not extend to the industry itself when it came to the government's new tax measure.

Ms Belinda Robinson, Chief Executive of APPEA, told the committee:

If we better understood what the motive was, we could have perhaps worked more closely together to try to look at the various options for delivering on that motive or that objective and then discussed what the implications might have been, perhaps even in the context of the broader energy policy position. 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 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. So I guess when we make these ad hoc decisions, it cannot be done within that context. We are just left to pick up the pieces.<sup>4</sup>

No discussions took place between Treasury and the North West Shelf Venture to discuss the implications of the change.

Of even greater concern was the revelation that the measure had been drafted by the Department of Treasury without any reference to the relevant expert department, the Department of Resources, Energy and Tourism<sup>5</sup>.

The LNG industry in Australia is at a crossroads. Australia is in danger of missing out on its window of opportunity presented by the expected huge growth in demand for LNG in the Pacific Basin over the next two decades.

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<sup>3</sup> Hon Martin Ferguson MP, Minister for Resources and Energy, Plenary Address at APPEA's 48<sup>th</sup> Annual Conference, 7 April 2008.

<sup>4</sup> Ms Belinda Robinson, Chief Executive, APPEA, *Proof Committee Hansard*, 15 July 2008, p. E2.

<sup>5</sup> Mr Matthew Flavel, Acting General Manager, Business Tax Division, Treasury, *Proof Committee Hansard*, 11 August 2008, p. E6.

Australia is the highest cost destination for LNG investment in the Asia-Pacific region with our industry facing significant geological and technical challenges and risks when compared with our competitors.

According to the industry, these risks and challenges have been counter-balanced by a number of “positives” including;

- our reputation for low sovereign risk
- our political stability; and
- our educated and skilled workforce.

The committee has heard clear evidence that this new tax measure is already causing considerable damage to Australia’s reputation for low sovereign risk.

It is difficult to imagine that a government would renege on a negotiated fiscal arrangement of some 30 years’ standing and not expect there to be any fallout from potential international investors looking at other major resource projects in Australia.

APPEA told the committee that the decision had ‘raised some investor eyebrows around the world’.<sup>6</sup> APPEA maintained the Commonwealth’s decision to change the fiscal arrangement for the NWS project and the way it was done, was more in line with the actions of governments in Venezuela and Trinidad.<sup>7</sup> They pointed to a fiscal stability agreement struck with the PNG government by Papua New Guinea LNG proponents, effectively freezing a fiscal regime for the life of that project in the context of what may be a possible requirement for Australia in the future.<sup>8</sup>

At a time when Australia should be doing everything possible to encourage and promote investment in our LNG industry so that we are well-placed for the coming boom in demand, our government has sent an appalling message to potential investors.

This is particularly disappointing as increasing the production of LNG and consequently the supply of LNG into China and other nations in the Asia Pacific, could make a meaningful contribution in addressing the challenge of climate change.

LNG projects require massive capital investments in the order of \$20 billion or more. One consequence of the long lead times to first production is that LNG projects also have long lead times for returns on investment. Significantly, the nature of the LNG market is such that producers are locked into long-term contracts which have usually been negotiated in a highly competitive market-place.

It is for these reasons that investors require the highest level of fiscal certainty from government.

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<sup>6</sup> Ms Belinda Robinson, Chief Executive, APPEA, *Proof Committee Hansard*, 15 July 2008, p. E1.

<sup>7</sup> Ms Belinda Robinson, Chief Executive, APPEA, *Proof Committee Hansard*, 15 July 2008, p. E4.

<sup>8</sup> Mr Noel Mullen, Deputy Chief Executive, APPEA, *Proof Committee Hansard*, 15 July 2008, p. E4.

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The committee has heard that there is little scope for the companies of the North West Shelf Venture to pass on this additional tax impost to their foreign clients due to the long-term nature of their contracts.

This new tax measure is bad for the industry in that it sends a message that the Australian government is willing to shift the fiscal goal posts once a project has commenced operation and after a project has been locked in to long-term fixed-price supply contracts.

In doing so, the government has seriously diminished one of the Australian LNG industry's key points of attraction for foreign investors and has, by implication, made it more difficult for Australia to compete with other nations trying to secure new LNG investments.

It was clear from the evidence presented to the committee that this was never considered by the government.

As Ms Robinson told the Committee:

If you are a board considering spending \$20 billion on an LNG project, you want to know, I think not unrealistically or unreasonably, that what arrangements you agree with the government for the lifecycle, for the full lifespan, of that investment, as has been the case forever in this country, are going to be the rules that apply through the development of that project. Otherwise you cannot make that investment. No board would agree to \$20 billion of their investors' money going into a project if they think that at any time on any sort of whim or for any reason a government will change that taxation revenue. They simply will not commit those funds.<sup>9</sup>

### **Unique secondary taxation arrangement for North West Shelf Project**

There has been some debate as to whether the arrangement allowing an exemption from excise on condensate for the NWS project was a negotiated fiscal arrangement or a 'loophole'.

Related to this is also a serious question mark over the Government's assertion that the NWS project had somehow benefited from a taxation advantage not available to other equivalent gas projects.

The government has argued that the exemption was designed solely to assist the NWS project to get off the ground and that, as the project was now mature and profitable, there was no further need to maintain the arrangement.

This is a convenient re-writing of history to help the government justify an additional \$2.5 billion tax.

The fiscal framework which helped create the NWS project was established by the Western Australian government of Sir Charles Court and the Federal government of then Prime Minister Malcolm Fraser.

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<sup>9</sup> Ms Belinda Robinson, Chief Executive, APPEA, *Proof Committee Hansard*, 15 July 2008, p. E9.

Since then the NWS project has paid billions of dollars in royalties and excise to both the Commonwealth and the State of Western Australia. In the 12 years between 1995–96 to 2006–07 the NWS project contributed \$6.5 billion in royalties alone.<sup>10</sup>

In other words, the NWS project partners honoured their side of the arrangement. On the other side, consecutive Coalition and Labor Federal governments maintained the fiscal arrangements put in place at the time.

The Government has now tried to argue that with this new tax measure it is in fact closing a loophole and removing a tax advantage. The Treasurer has been quoted in the media as saying that

most people in the industry believed it was time the tax advantage for the North West Shelf ended<sup>11</sup>.

The response from Mr Don Voelte, CEO of Woodside (one of the NWS partners) to this claim was emphatic:

this is not a loophole or a free ride which has come to an end. This is a negotiated fiscal arrangement which formed the basis of Australia's largest resource development.

Treasury officials told the committee:

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.<sup>12</sup>

But in a response to a question on notice from the Estimates hearings, Treasury's line had softened:

Treasury does not have any information to confirm or reject the original arrangements asserted by Woodside.

In evidence before the Committee, Treasury appeared confused about the secondary taxation status of the NWS project as demonstrated by the following evidence by Mr Brown:

...the project has had an exemption from all secondary taxation at the Commonwealth level, not counting the royalty arrangement which is in place with the states. It has been exempt from crude oil excise for 30 years.<sup>13</sup>

And a bit later Mr Brown said:

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<sup>10</sup> North West Shelf Venture, *Submission 3*, p. 4.

<sup>11</sup> Tax on NW Shelf fair, says Swan, *The West Australian*, 21/05/2008, page 16.

<sup>12</sup> Mr Paul McCullough, Acting General Manager, Revenue Group, Treasury, *Proof Committee Hansard*, 11 August 2008, p. E2.

<sup>13</sup> Mr Paul McCullough, Acting General Manager, Revenue Group, Treasury, *Proof Committee Hansard*, 11 August 2008, p. E4.

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...the project that we are talking about has enjoyed for 30 years an exemption from the secondary taxation regime to which it was subject.<sup>14</sup>

The reality is that this evidence was incorrect.

The North West Shelf Project has paid royalties on all products produced by the Joint Venture and excise on all oil produced from the venture from day one.

Specifically, the North West Shelf Project has paid:

- Petroleum royalties, set a rate of between 10 and 12.5% of the net wellhead value of production from each licence area. Unlike PRRT, petroleum royalties are payable from the commencement of production from each licence area. Commonwealth royalties apply to North West Shelf production, while state/territory royalties apply to projects under non-Commonwealth jurisdiction; and
- Crude oil production excise associated with crude oil produced from each petroleum field. Crude oil production on the NWS has not been excise exempt.

Treasury has since confirmed in an e-mail to the Committee secretariat that this understanding is indeed correct.

For all the government's bluster on the 'loophole' issue, Treasury cannot provide any information that would indicate there was in fact not a clear understanding that the exemption was part of an agreed fiscal arrangement.

The loophole issue is itself a red herring from the government designed to divert attention away from the nature of the fiscal arrangements agreed to for the NWS project as compared to similar oil and gas projects since.

The North West Shelf project was required to pay royalties and excise from first production - that is irrespective of whether profits were made.

Offshore gas projects since are subject to the profits-based Petroleum Resource Rent Tax (PRRT), which includes a range of deductions for 'allowable expenditure' (including compounding).

This was confirmed by Mr Hartwell, Head of the Resources Division in the Department of Resources, Energy and Tourism, before Senate Estimates on 2 June 2008:

**Mr Hartwell**— ... on all projects offshore—with the exception of the North West Shelf leases—they are subject only to the petroleum resource rent tax. In the North West Shelf they are subject to excise plus royalties.

**Senator CORMANN**—So all projects offshore other than the North West Shelf do not pay excise or royalties, including excise on condensate?

**Mr Hartwell**—That is right, because they are subject to the petroleum resource rent tax.

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<sup>14</sup> Mr Paul McCullough, Acting General Manager, Revenue Group, Treasury, *Proof Committee Hansard*, 11 August 2008, p. E5.

The net effect is that those projects often do not pay any secondary taxation for many years after production commenced. This system of secondary taxation was introduced after the fiscal arrangements for the NWS project were put in place. The structure of the PRRT system recognises the marginal nature of these capital intensive projects with high investment costs and low initial returns to help facilitate those investments.

The head of the Resources Division in the Department confirmed this before Senate Estimates on 2 June 2008:

**Mr Hartwell**—Our experience would be, given it is a profits-based tax, most projects would not incur PRRT until five to 10 years at least. Sometimes the more marginal ones may not even incur a liability on petroleum resource rent tax at all.

This means that the North West Shelf project carried more risk for an extended period of time when compared to other offshore gas projects today.

In an ASX announcement the day after the budget, Woodside CEO Don Voelte said:

relief from condensate excise was among a range of measures between the North West Shelf participants and the Commonwealth and Western Australian governments that underpinned the economic viability of the project, *while guaranteeing early financial returns to government.*<sup>15</sup>

Importantly, Mr Hartwell from the Resources Division in the Department has previously argued before Senate Estimates that if the NWS project had in fact been subject to PRRT, that over the life of the project the secondary taxation liability would have been about the same.<sup>16</sup>

If that is indeed the case, then clearly the NWS project did not enjoy a taxation advantage and would now be actually worse off as a result of this measure compared to other offshore gas projects subject to PRRT.

The evidence of Eve Howell, Chief Executive Officer of the NWS Venture, indicated significant concerns that the new tax arrangements would place the NWS project at a comparative disadvantage:

I think the comment has been made about level playing fields and so on. We would like to see not just from our own work but from the government departments some evidence that this really is a level playing field.<sup>17</sup>

The evidence indicates the government has mounted a deceptive and dishonest public campaign to paint the NWS project as being the recipient of a free ride through the excise exemption.

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<sup>15</sup> Woodside ASX Announcement, Imposition of excise on North West Shelf condensate, 14 May 2008

<sup>16</sup> Mr Hartwell, Head of Resources Division, Department of Industry, Tourism and Resources, Senate Estimates, *Economics Committee Hansard*, 31 May 2005, p. E7;

<sup>17</sup> Ms Eve Howell, Chief Executive Officer, North West Shelf Venture, *Proof Committee Hansard*, 15 July 2008, p. E19.

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To properly assess fairness or whether there has been an unfair advantage, taxation arrangements for relevant gas projects would have to be considered over the life of the project. Capital intensive gas projects since 1987 will incur no secondary taxation liability in the early stages of the project and a tax on profits once the project has become profitable. The NWS project had its secondary taxation liability more evenly spread across the whole project life cycle. The NWS project paid royalties and excise irrespective of profitability.

The Government now no longer wants to recognise the comparatively higher contribution made by the NWS in the earlier years and increase taxes based on a perception of increased profitability in the later years.

During the inquiry the proposition was put to Treasury that the government needed to substantiate its assertion that the NWS project enjoyed a taxation advantage compared to offshore gas projects subject to PRRT. Treasury was dismissive only stating that:

**Mr Brown**—The project that we are talking about has enjoyed for 30 years an exemption from the secondary taxation regime to which it was subject. Other projects are subject to another secondary taxation regime and are not exempt from that.

The NWS project was not of course exempt from the secondary taxation regime to which it was subject and neither Treasury nor the government have presented any evidence that it had gained an unfair advantage from those fiscal arrangements.

On the contrary, it is clear the NWS project accepted significant additional risk by being required to pay excise and royalties from first production and in doing so providing early returns for government.

Furthermore, the Government appears to have underestimated the impact of this measure on future additional investment on the NWS itself.

Additional investment on the NWS subject to the excise regime, including the additional excise on condensate, will not be deductible while for projects subject to PRRT it would be.

This was pointed out by the NWS Venture in its submission:

For fields that have exceeded 30 million barrels of excise free production, future investment decisions to either enhance or expand production from a field or project will now face a fundamentally different risk/reward framework. As the excise system does not allow a deduction for incurred costs (unlike the PRRT and royalty regimes), project proponents may consider alternative investments if the impact of excise adversely impacts on project economics, leaving hydrocarbon resources in the ground that would otherwise be economic to produce.<sup>18</sup>

The NWS project now faces the clear possibility of being placed at a comparative disadvantage in taxation terms to other offshore gas projects which did not have to accept the same requirement for early taxation payments.

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<sup>18</sup> North West Shelf Venture, *Submission 3*, p. 10.

It is clear that all these issues should have been considered and addressed by the Henry Review before any changes were made to the fiscal settings for the NWS project in this ad hoc fashion.

### **Compliance costs for gas projects**

The government's failure to consult with the industry on this new tax measure has left the industry with a compliance nightmare.

It is clear that neither Treasury nor Finance fully understood the practical implications for implementing this new tax measure.

Treasury had assured the committee that implementation of the new measure, which came into effect on Budget night, was relatively straightforward.

The evidence from industry confirmed that Treasury had badly misjudged the implications.

Noel Mullen, Deputy Chief Executive, APPEA, told the committee:<sup>19</sup>

**Mr Mullen**—There seems to be a misunderstanding that there is some parallel between the royalty and excise regimes. While they apply in tandem, they are very different regimes. ...

**Senator CORMANN**—So Treasury had that misunderstanding, did they?

**Mr Mullen**—Well, the royalty regime applies on a licence area basis, which bears no resemblance to the geography or geology of a field, whereas the excise regime is very much field and accumulation driven. The information that would have historically been kept by companies in relation to royalty will bear very little resemblance to what is required for the excise regime. So really to assume that someone is in a position technically to move straight into a new regime, such as on budget evening, probably fails to understand the differences that exist between the two systems.

Of even greater concern was the evidence that the new tax regime would require on-shore gas producers to incur significant compliance costs even though they may never be required to pay the excise.

**Mr Mullen**—The evening of the announcement, which was the proposed date of effect, there were obviously some obligations which immediately flowed to both the North West Shelf participants and onshore producers. ... While on the surface the number of fields which might be relevant in the North West Shelf is quite small, because the measure applies onshore, there are numerous fields onshore which now are captured by the regime.

The North West Shelf partners may be in a better position to outline where they are on their dealings. But certainly a lot of onshore players who have never been captured by the regime before are still coming to terms with what they are required to do even though in reality they will probably not incur an excise liability for one reason or another.

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<sup>19</sup> Mr Noel Mullen, Deputy Chief Executive, APPEA, *Proof Committee Hansard*, 15 July 2008, p. E7.



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**Senator CORMANN**—So they would have additional compliance costs and an additional compliance burden but there will actually not be any additional revenue for the Commonwealth, as far as you can see?

**Mr Mullen**—Certainly based on the information we have, it is very unlikely that any onshore discoveries will incur an excise liability.

The evidence before the committee indicates these on-shore companies will incur compliance costs with no benefit at all to Commonwealth revenues. Domestic gas consumers in Western Australia, however, will face increased gas prices as these additional compliance costs will inevitably also be passed on.

### **Higher domestic gas prices**

Apart from compliance costs placing upward pressure on domestic gas prices, it is inevitable that gas producers will seek to recover the revenue they will lose from the removal of the excise exemption.

Woodside's Chief Financial Officer Mark Chatterji has warned gas consumers that his company cannot absorb the cost of the tax increase:

In order to stay competitive, businesses seek to pass cost increases on to their customers. This is especially true for Woodside, given that we are reinvesting 100 per cent of our profits and borrowing billions of additional dollars in order to build our Pluto LNG Project here in Western Australia.<sup>20</sup>

The NWS will inevitably seek to pass on the additional costs arising from the excise changes as domestic gas contracts come up for renewal. Given the NWS supplies 60% of the gas to the WA domestic market this will place strong upward pressure on gas prices at a time when there is already pressure on gas prices.

Evidence to the committee also indicated that LNG contracts are long-term agreements, often negotiated in a 'buyers market', with little scope for price variation.

The NWS project will lose \$2.5 billion to this new tax measure over the period of the forward estimates.

Ms Robinson told the committee:

The North West Shelf is taking the hit. Of course, it's going to be up to them as to how they pass that through.

They have long-term contracts for the sale of their gas. I think that is a really important thing to remember with the gas industry; they are subject to long-term contracts. Some of them are not particularly favourable, but they were signed off at a particular time that you wear. So the options really are to take it on the chin, take it off your bottom line or to pass it through in your future contracts—so from here on in. Of course, most companies are required to stick with their rates of return or

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<sup>20</sup> Andrew Probyn, 'Woodside threatens to pass on proposed tax to WA households', *The West Australian*, p. 1.

their hurdle rates that are agreed through their boards, so that means that they need to be passed through in some way, shape or form.

Apart from the cost of the tax itself being passed on, there is also going to be further pressure on the price of gas as a result of not encouraging increases in supply at a time of significant increases in demand. The way the new tax was introduced, the impact that this will have on our sovereign risk profile and the implications of that in terms of investor confidence could well make investment in new gas projects less attractive.

Potential investors contemplating new gas projects will need to factor in higher gas prices to ensure the economics of the project are sound. As there is little price flexibility in the export market, those higher prices, again are more likely to be paid by domestic consumers in Western Australia.

As Ms Robinson said in evidence to the Committee:<sup>21</sup>

**Ms Robinson**—I guess the point we are making is that it is simply one that will affect the economics of whether or not the project goes ahead. One of the reasons why the excise exemption was there was this recognition that condensate was co-produced with gas and that that was often the driver or the reason why we were able to commercialise the gas project. Once that goes, it makes it much more difficult to commercialise the project because that is of much higher value. So the decision then becomes not one as to how you pass it off or where you cut the costs. It is just one about whether it is economic for the project to go ahead at all.

**Senator CORMANN**—But your recommendations are very specific. You want the committee to note that gas producers may now require higher prices on gas sales to underpin or support project economics. So what does that mean in practice?

**Ms Robinson**—Well, that is one way of addressing those economics. If the project is to go ahead, obviously the sales price of the products that you are selling will have to be higher because it has to make up that difference.

**Senator Eggleston** – If you are not getting the income from condensate to balance out the-

**Ms Robinson** – Because you are having to pay the excise on the condensate, which was otherwise exempt from the excise.

**Senator Eggleston** – So your income has reduced. Therefore, you will have to increase costs to the buyer?

**Ms Robinson** – Yes, that is right. If you meet your hurdle rate, which is a marginal rate to begin with.

It should be noted that while the \$2.5billion raised by this new tax measure will go to general revenue for the benefit of all Australians, the cost from higher gas prices will be paid only by Western Australian families and businesses.

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<sup>21</sup> Ms Belinda Robinson, Chief Executive, APPEA, *Proof Committee Hansard*, 15 July 2008, p. E8.

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The warnings of higher domestic gas prices as a result of this new tax measure have fallen on deaf ears with the Premier of Western Australia, Mr Alan Carpenter, simply stating:

...the companies have been the beneficiaries of the tax exemption and it is up to them to respond on the impact to their bottom line and operations

This is, at best, a serious misjudgment of the situation. At worst, it is a callous disregard for the impact on Western Australian families of higher gas prices caused by this new tax measure.

Even after Woodside publicly confirmed that it may have to pass the additional \$2.5 billion cost on to their customers, Premier Alan Carpenter decided to shoot the messenger attacking Woodside rather than to commit to representations in Canberra on behalf of Western Australia.<sup>22</sup>

Treasury confirmed to the committee that it had not done any modelling on the impact of this new tax measure on domestic gas prices. In light of Mr Chatterji's comments, this would appear to be wilfully negligent on the part of the government.

Treasury was not prepared to rule out an impact on the price of domestic gas.<sup>23</sup>

**Senator CORMANN**—So you can absolutely rule out that there will be any flow-on effect in terms of domestic gas prices as a result of this measure?

**Mr Brown**—I am saying that the prices you are talking about are generally set in international markets and this would not have any impact on those prices.

**Senator CORMANN**—So you cannot rule out that there would be a flow-on effect on domestic gas prices.

**Mr Brown**—All I can say is that I would not expect there to be.

## Summary

By ambushing the oil and gas industry with its Budget night announcement, the government has already done significant damage to Australia's reputation for low sovereign risk and as an attractive destination for resource-based investment.

It has also created a compliance nightmare for both itself and oil and gas producers.

There can also be no question that domestic gas prices will rise for Western Australian families and businesses.

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<sup>22</sup> Andrew Probyn and Robert Taylor, 'Woodside gas threat not fair: Premier', *The West Australian*, 21 August 2008, p. 4.

<sup>23</sup> Mr Colin Brown, Acting General Manager, Tax Analysis Division, Treasury, *Proof Committee Hansard*, 11 August 2008, p. E3.

The price competitiveness of Australia's LNG producers has been damaged and Australia's ability to fully exploit its gas resources has been diminished.

This is the price we are paying for a naked grab for cash by a new government which over-committed itself with big spending promises during an election campaign.

The North West Shelf project has been viewed as a soft target for the government.

More than 30 years of trust and cooperation between the venture and the government of the day had helped ensure Australia's gas resources would be exploited for the benefit of all Australians.

Having delivered on their side of the deal, the venture partners have every right to feel they have been treated shabbily by this new government.

The oil and gas industry has made it abundantly clear that it is neither afraid of nor opposed to sensible tax reform.

This should have been done through the Henry review against the background of a strategic framework which would allow the industry to grow and position itself for the opportunities of the coming decades.

As Ms Robinson put it:

We have a choice. If we want to deliver benefits to Australia from Australia's oil and gas industry, we can just keep taxing it into oblivion or paralysis or we can look at the way we can use our fiscal regime to grow the industry so it can continue and multiply the benefits that it delivers back.<sup>24</sup>

Instead the government has opted to use a blunt taxation instrument to prop up its own budget surplus and further burden the industry.

The irony of this move will not be lost on Western Australians who pride themselves on the massive contribution their state's resources sector makes to the national economy.

Prior to the 2007 election Kevin Rudd said:

Here in the West, so much money is generated for the public revenue in Canberra out of these great resource projects. But you know something? Not enough of that money is given back.

The West gives so much to the nation's economic development. The West is currently being short-changed.<sup>25</sup>

The removal of the exemption on excise on condensate for the NWS project takes an additional \$2.5 billion out of Western Australia and returns nothing to the state or its people.

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<sup>24</sup> Ms Belinda Robinson, Chief Executive, APPEA, *Proof Committee Hansard*, 15 July 2008, p. E13.

<sup>25</sup> Mr Kevin Rudd, Federal Labor Leader, Doorstop Interview with Stephen Smith, Shadow Minister for Education and Training at Thornlie Senior High School, 2 August 2007.

Western Australian gas consumers will end up carrying the burden of this additional tax as it is inevitably passed on.

Finally, there is a real concern about the long term damage this ill-conceived revenue measure will do to Western Australia's ability to unlock the huge potential of its off-shore gas resources for the benefit of future generations of Australians.

Coalition Senators note that Labor did not go to the election promising new taxes.

The Coalition is opposed to increasing taxes – we want to reduce the burden of taxation.

In short, Coalition Senators consider that it is economically irresponsible to increase taxes when the economy is slowing.

Accordingly, the Coalition Senators on the committee do not believe this additional tax measure should be supported.

**Senator Alan Eggleston**

**(Deputy Chair)**

**Senator Mathias Cormann**

**Senator David Bushby**

**25 August 2008**



# **APPENDIX 1**

## **Submissions Received**

<b>Submission Number</b>	<b>Submitter</b>
1	Dr Richard Griffiths, NSW
2	Australian Petroleum Production & Exploration Association Ltd, WA
3	North West Shelf Venture, WA





## **APPENDIX 2**

### **Public Hearings and Witnesses**

#### **Perth Legislative Assembly, Perth, 15 July 2008**

##### **Australian Petroleum Production and Exploration Association (APPEA)**

Ms Belinda Robinson, Chief Executive

Mr Noel Mullen, Deputy Chief Executive - Commercial and Corporate

##### **North West Shelf Venture (NWSV)**

Ms Eve Howell, Executive Vice President

#### **Parliament House, Canberra, 11 August 2008**

##### **The Treasury**

Mr Paul McCullough, Acting Executive Director, Revenue Group

Mr Matthew Flavel, Manger, Business Tax Division

Mr Colin Brown, Acting General Manager, Tax Analysis Division

**Dr Richard Griffiths**

