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7 July 2008

The Committee Secretary
Senate Economics Committee
Department of the Senate
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Parliament House
Canberra ACT 2600

Email: economics.sen@aph.gov.au

Dear Committee Secretary

Inquiry into the Excise Legislation Amendment (Condensate) Bill 2008 and the Excise Tariff Amendment (Condensate) Bill 2008

The Australian Petroleum Production & Exploration Association (APPEA) is the peak national body representing the collective interests of companies engaged in petroleum exploration, development and production in Australia. The Association's membership comprises companies that account for around 98 per cent of Australia's petroleum production and the vast majority of exploration. Please find attached APPEA's submission to the Inquiry.

The recommendations contained in the submissions are as follows:

Recommendation 1: The Committee notes that producers of condensate (both offshore and onshore) affected by the decision will need to address a range of compliance and verification obligations and that similar principles in defining 'prescribed condensate production areas' should apply as currently exist for crude oil production (that is, a 'relevant accumulation').

Recommendation 2: In recognition that excise duty is unlikely to be payable on current onshore discoveries, new reporting/compliance burdens will be placed on onshore producers and the negative impact the decision may have on exploration decisions in onshore frontier areas, the Committee recommends that the decision to apply excise to condensate production 'onshore' be opposed. It is also recommended that the Committee recommends the deferred introduction of the measure 'offshore' until all administrative and compliance issues are resolved.

Recommendation 3: The Committee notes that the imposition of excise could have a negative impact on future development decisions for fields that have, or will exceed a 30 million barrel allowance.

Recommendation 4: The Committee notes that the extension of crude oil excise represents an undermining of the economic efficiency and where excise is payable, gas producers may now require higher prices on gas sales to underpin or support project economics.

Recommendation 5: The Committee notes that rapidly escalating cost pressures confronting the industry are constraining growth in profits.

Recommendation 6: The Committee notes that adverse changes to fiscal settings following the completion of investment decisions can negatively influence investors' perceptions of Australia's sovereign risk and diminish its ability to attract further investment and supports the inclusion of petroleum specific issues in the Government's announced review of the Australian Taxation System.

Yours faithfully

Belinda Robinson
CHIEF EXECUTIVE

Encl.

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SUBMISSION TO THE SENATE ECONOMICS COMMITTEE

"Inquiry into the Excise Legislation Amendment (Condensate) Bill 2008 and the Excise Tariff Amendment (Condensate) Bill 2008"

AUSTRALIAN PETROLEUM PRODUCTION & EXPLORATION ASSOCIATION (APPEA) LTD

JULY 2008

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SECTION 1: CURRENT RESOURCE TAXATION FRAMEWORK

1.1 Legislative Framework

Under the terms of the 1979 Offshore Constitutional Settlement and the division of powers provided for under the Australian Constitution, the power to impose both taxation and other charges on oil and gas production has been divided between the Commonwealth and States/Territories. The Commonwealth holds title for all areas seawards of the outer boundary of the territorial sea ('offshore' areas) while the States/Territories control areas landwards of this boundary ('onshore' areas). As part of the Settlement, a common mining code was adopted covering all petroleum regulation in submerged lands.

The provisions of the Australian Constitution restrict the power of the States/Territories to impose certain types of charges to the extent that the major tools for revenue raising by these governments are royalty based charges. The Australian Government is less constrained and thus has the power to levy excise as well as royalty and profit based taxes. This distinction is important and provides the basis for the existence of several secondary taxation regimes applying to Australian oil and gas production.

1.2 Current Framework

At present, the Commonwealth resource (secondary) taxation framework that applies to petroleum production in Australia is broadly as follows:

- all 'offshore' projects, with the exception of those production licences derived from Exploration Permits WA-1-P and WA-28-P, are subject to the provisions of the *Petroleum Resource Rent Tax Assessment Act 1987*;
- production sourced from licences derived from Exploration Permits WA-1-P and WA-28-P are subject to Commonwealth crude oil excise and Commonwealth petroleum royalty; and
- onshore production and that sourced from projects located in submerged lands under state jurisdiction is subject to Commonwealth crude oil excise and royalty under the relevant state/territory jurisdiction.

1.3 Petroleum Resource Taxes in Australia

a) Petroleum Resource Rent Tax (PRRT)

PRRT is broadly a profits based tax with the following basic features:

- it is assessed on a project basis;
- liability to pay PRRT is on a producer/company;
- it is assessed at a rate of 40 per cent;
- is payable quarterly on an instalment basis;
- a liability is incurred when all allowable expenditures (including compounding) have been deducted from assessable receipts;
- assessable receipts include the amounts received from the sale of all petroleum (a 'marketable petroleum commodity');

- deductions include capital or operating costs that relate to the petroleum project, and are deductible in the year they are incurred. Deductible expenditures include exploration, development, operating and closing activities;
- expenditures which are non-deductible include financing costs, some indirect administration costs, income tax and cash bidding payments; and
- undeducted expenditures are compounded forward at a variety of set rates depending on the nature of those expenditures and the time that they are incurred prior to the application for a production licence.

b) Petroleum Royalties

While the specific details of the various royalty regimes vary across jurisdictions in Australia, the basis features are as follows:

- royalty is levied on a licence area basis;
- liability to pay royalty is on the net wellhead value of production;
- it is levied at rates of between 10 and 12 ½ per cent of the wellhead value;
- limits often apply to deductions such that a minimum royalty liability must be paid in any single period (usually from the commencement of production);
- costs incurred between the wellhead and the point of sale (ie post wellhead costs) are deducted from gross receipts to ascertain the wellhead value. Deductible costs can include the post wellhead depreciated value of capital equipment, an allowance for the cost of capital, operating expense and crude oil excise (in some cases).

c) Crude Oil Excise

Crude oil excise is calculated as a percentage of the volume weighted average of realised f.o.b price (VOLWARE) made from a designated region. Crude oil is subject to excise in a manner such that higher percentage rates apply to higher levels of production or liftings from each prescribed production area.

The excise scales that apply to production from each prescribed production area are dependent on the date of discovery and/or the commencement of production. The applicable excise scales and definitions that currently apply are outlined below.

EXCISE RATES ON CRUDE OIL PRODUCTION				
Annual Production		**Excise Rates (% of VOLWARE Price) (1)**		
megalitres	**'000's barrels**	**'old' oil (2)**	**'intermediate scale' oil (3)**	**'new' oil (4)**
0 - 50	0 - 315	0	0	0
over 50 - 100	over 315 - 629	0	0	0
over 100 - 200	over 629 - 1259	0	0	0

over 200 - 300	over 1259 - 1888	20	0	0
over 300 - 400	over 1888 - 2517	30	15	0
over 400 - 500	over 2517 - 3146	40	30	0
over 500 - 600	over 3146 - 3776	50	50	10
over 600 - 700	over 3776 - 4405	55	55	15
over 700 - 800	over 4405 - 5034	55	55	20
over 800	over 5034	55	55	30

(1) Volume weighted average realised price f.o.b of crude oil sales in a given calendar month
(2) Oil discovered before 18 September 1975
(3) Oil production from fields discovered before 18 September 1975 and undeveloped as of 23 October 1984
(4) 'New oil' is oil produced from naturally occurring discrete accumulations discovered on or after 18 September 1975 (reference 1990 Federal Government Report on *Petroleum Production Taxation* page 47)

In addition to the above, the current crude oil excise provisions allow for the following:

- the exemption from excise of the first 4,767.3 megalitres or 30 million barrels of cumulative crude oil production from each petroleum field where excise applies;
- condensate marketed or produced separately from crude oil is excise free; and
- the exemption from excise of all gas production, including liquefied petroleum gas, liquefied natural gas and commercial gas/ethane.

1.4 Crude Oil Excise – Historical Development

The crude oil excise regime has been in place since the mid 1970s. As indicated above, it applies in conjunction with the Commonwealth royalty or state/territory royalty regime (depending on the location of a project), with other projects being subject to PRRT.

It was originally introduced as a levy on each barrel of production sold from eligible areas, and was then substantially modified in 1983 such that it then applied at varying rates depending on the discovery and development date of the relevant prescribed production area. In April 1984, the 'new oil' excise scale was introduced, while the 'intermediate scale' was introduced at the end of 1984 to encourage the development of satellite fields that had become uneconomic under the 'old oil' scale. In July 1987, the 30 million barrel excise exemption for each field was introduced to further stimulate the development of oil discoveries.

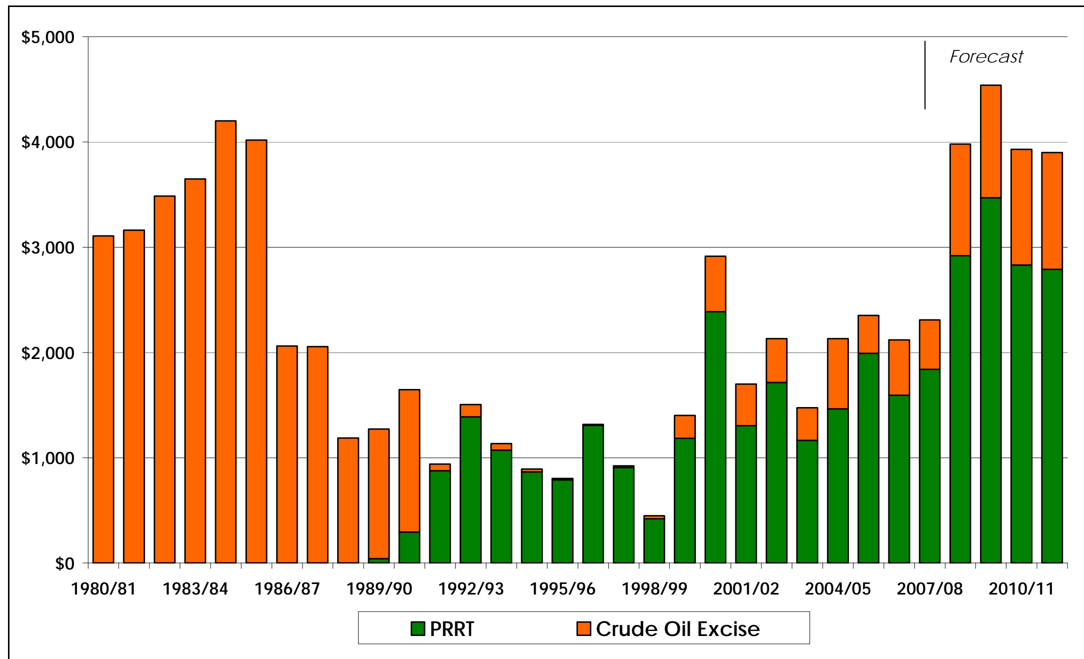
Prior to the mid 1980s, crude oil production excise applied to all petroleum projects in Australia. Following the introduction of PRRT, crude oil excise (and Commonwealth royalty) continued to apply to the Bass Strait project area and production licences derived from the NWS permit areas. Crude oil excise (and

state/territory royalty) also continued to apply to production sourced from onshore projects and those in submerged lands under state/territory jurisdiction.

In 1990, PRRT was extended to cover the Bass Strait project, however the crude oil excise and Commonwealth royalty regime continues to apply to permits derived from the NWS project area.

PRRT and crude oil excise collections are outlined in Chart 1. Commonwealth royalty data is not separately released by the Australian Government.

Chart 1: Petroleum Taxation Payments (Source: Budget Papers)



1.5 Excise Treatment of Condensate

In conjunction with the 1977/78 Federal Budget, a number of announcements were made covering the operation of the excise regime. In relation to condensate, the following was announced:

> *"The levy will not apply to condensate marketed separately from a crude oil stream; such condensate may now be sold at commercially negotiated prices. Nor will the levy apply to liquefied petroleum gas fields yet in production. This will assist the marketing of LPG and condensate from fields already discovered but not yet developed in the North West Shelf and Cooper Basin. Condensate sold commingled in a crude oil stream will continue to be treated as crude oil for pricing and levy purposes."*

Source: Parliamentary Library, 27 May 2008

The decision did not provide a free rate of duty for condensate. Rather, it ensured that condensate was not covered by the provisions of the excise regime (that is, it

was effectively exempted from the regime). The measure was aimed at assisting investment decisions for both the Cooper Basin and North West Shelf areas. Condensate and gas production remained subject to petroleum royalties.

A further adjustment was introduced in 1995 which allowed for condensate that was either produced or marketed separately from crude oil to be excise exempt. This ensured that condensate was not regarded as crude oil for the purposes of the excise regime merely because of the fact that it was commingled with crude oil post the point of production. This change can be seen as a further reaffirmation of the exemption from condensate from the crude oil excise regime. Subsequent amendments were also made to the excise regime in 1997 and 2001 and in both cases, no suggestion was made of any intention to modify the excise treatment of condensate production.

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.

SECTION 2: BUDGET DECISION AND IMPLEMENTATION

2.1 The 2008/09 Budget Announcement

On 13 May 2008, the Federal Government announced an intention to remove the exemption of condensate from the crude oil excise regime. The Treasurer stated that the "..*measure will increase the return to the Australian community from allowing private interests to extract non-renewable energy resources located in the North West Shelf project area and onshore*". The announcement also indicated that:

> *"Condensate will be subject to the same excise rates as crude oil from petroleum fields discovered after 18 September 1975"*
>
> and
>
> *"The first 4,767.3 megalitres (or 30 million barrels) of crude oil produced from a field is excise exempt from Crude Oil Excise. Past production of condensate from a petroleum field will contribute towards meeting this threshold before the Crude Oil Excise becomes payable".*

The Government subsequently introduced the *Excise Tariff Amendment (Condensate) Bill 2008* and the *Excise Legislation Amendment (Condensate) Bill 2008* to give legal effect to the changes. The former amends the *Excise Tariff Act 1921*, while the later amends the *Petroleum Excise (Prices) Act 1987* and provides for a consequential amendment to the *Petroleum Revenue Act 1985* (which provides for a separate regime for production sourced from the Barrow Island project).

2.2 Implementation Requirements

All producers of condensate covered by the announcement (both offshore and onshore and irrespective of the level of production) will be required to comply with both the provisions of the legislation and any compliance/reporting obligations that may be imposed by the Australian Taxation Office (ATO).

To date, APPEA has identified the following procedural issues for those companies affected by the decision.

- A producer must apply for and be granted a licence to produce condensate.

- A producer must nominate all relevant petroleum fields for the granting of each 30 million barrel excise free allowance – the ATO is required to certify/confirm the respective nominations. As the definition of a 'field' is based on geological criteria (as provided for under the *Excise Tariff (Fields) Guidelines 1997 No.1)*, the timelines associated with the ATO's confirmation of the relevant field nominations (which again is relevant to all offshore and onshore fields impacted by the measure) is unclear.

  APPEA understands that under the amending legislation, offshore fields in production prior to 1 July 1987 are not eligible for a 30 million barrel allowance (discussions with the ATO have tentatively confirmed this understanding). This seems contrary to the statement by the Treasurer suggesting that past production from all fields will be eligible for the allowance. Conversely, only production after 30 June 1987 counts towards each 30 million barrel allowance for onshore petroleum fields.

- Producers must provide historical production data for all nominated petroleum fields. Advice that has been provided to APPEA by a number of member companies is that historical data may not have been maintained in all instances (this was not a statutory requirement). This is further complicated by the fact that current field operators may not have access to historical production data where a change in field operator-ship has taken place since the commencement of production.

- Nomination by the producer of relevant 'prescribed condensate production areas'. This forms the basis under the legislation for the levying of an excise duty on condensate production. Under the Excise Tariff Amendment (Condensate) Bill 2008, the following definition applies:

  > "***prescribed condensate production area*** *means a condensate production area prescribed by by-laws (which, without limiting the generality of the foregoing, may be a relevant accumulation, a well, an oilfield or a gas field)"* (Section 27):

  This is a wide definition that places gives a significant degree of discretion to the ATO. However, the *Excise Tariff Act 1921* provides guidance on how this discretion should be applied. Specifically, Section 3 of that Act defines 'new oil' as oil produced from a 'relevant accumulation'. In this context,

the appropriate definition of a '*prescribed condensate production area*' should be consistent with the treatment that already exists under the relevant legislation.

- Provision of details (in consultation with the ATO) on processes and procedures to be put in place to monitor, record and verify condensate production to satisfy the ATO that adequate information is generated and maintained.

- Subject to the quantum of production (in terms of both the 30 million barrel allowance and the level of production) and requirements imposed by the ATO, determine the relevant VOLWARE price for condensate sales made during an excise period (as provided for under the provisions of the *Petroleum Excise (Prices) Act 1987*), ascertain individual excise liabilities for participants within a relevant joint venture and acquit the relevant duty calculated for the period.

The practical issues associated with the measure applying from Budget night have seemingly in part been recognized by the inclusion of a 60 day registration/ compliance period to address a number of the matters raised above. APPEA is not in a position to comment on whether this period is sufficient for all parties to comply with the legislation and/or details of the announcement, however the complexity of the of the crude oil excise regime, the capturing of new entities under the provisions of the amending legislation and the need for both data to be collected and new systems to be implemented, highlights the importance of appropriate implementation timelines and consultations.

Recommendation 1: The Committee notes that producers of condensate (both offshore and onshore) affected by the decision will need to address a range of compliance and verification obligations and that similar principles in defining 'prescribed condensate production areas' should apply as currently exist for crude oil production (that is, a 'relevant accumulation').

SECTION 3: SPECIFIC COMMENTS

3.1 Coverage of Onshore Condensate Production

Information provided to APPEA in relation to onshore production indicates that very few petroleum fields will have exceeded the 30 million barrel excise free allowance threshold. Even in the very limited cases where this threshold may have been passed, the annual levels of production that will apply to the relevant prescribed production areas will be insufficient to incur an excise liability (that is, combined crude oil and condensate production will be less than the annual 3.146 million barrels required before a liability is incurred).

In effect, there is not expected to be any duty incurred for onshore condensate production in Australia. Despite this, onshore producers will be required to meet the verification, administrative and compliance obligations imposed by the ATO arising from the announcement. As many of the pre-Budget reporting processes were largely confined to royalty requirements (which are centered around

licence areas, not petroleum fields or prescribed production areas), new processes may need to be implemented to account and/or verify a zero excise liability.

The imposition of a potential excise liability on onshore condensate production (in the event of a future discovery) may act to discourage future exploration decisions. In particular, this may have implications for exploration in frontier onshore areas where the risk/reward balance can be different to more traditionally explored regions. High risk frontier exploration requires a fiscal framework that provides an incentive for risk capital to be directed towards these areas – the imposition of a potential excise liability on future discoveries clearly sends a negative fiscal signal.

Recommendation 2: In recognition that excise duty is unlikely to be payable on current onshore discoveries, new reporting/compliance burdens will be placed on onshore producers and the negative impact the decision may have on exploration decisions in onshore frontier areas, the Committee recommends that the decision to apply excise to condensate production 'onshore' be opposed. It is also recommended that the Committee recommends the deferred introduction of the measure 'offshore' until all administrative and compliance issues are resolved.

3.2 Future Development Decisions

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.

Recommendation 3: The Committee notes that the imposition of excise could have a negative impact on future development decisions for fields that have, or will exceed a 30 million barrel allowance.

3.3 Economic Efficiency

The original decision to replace the crude oil excise/royalty system for offshore areas was an explicit recognition by the Government of the economic efficiency benefits flowing from the petroleum resource rent tax regime (which is a 'profits based' system). The 2008/09 Budget decision to effectively extend the crude oil excise regime to a range of offshore and all onshore areas seems to be inconsistent with the stated economic efficiency principles.

The potentially adverse impact of extending excise to condensate is compounded by the fact that condensate is generally produced in association with gas, the economics of which are more challenging than conventional oil projects. It is generally recognized that the economics of gas projects in Australia are improved by the production of associated condensate. Indeed, both

domestic and export gas projects (which are characterized by high upfront capital costs, flat production profiles and relatively long periods prior to the generation of positive project return for an investor) have historically been aided by associated condensate production that has directly underpinned positive investment decisions. Such a situation was clearly recognised as part of the 1977 Budget decision not to include condensate as part of the excise system.

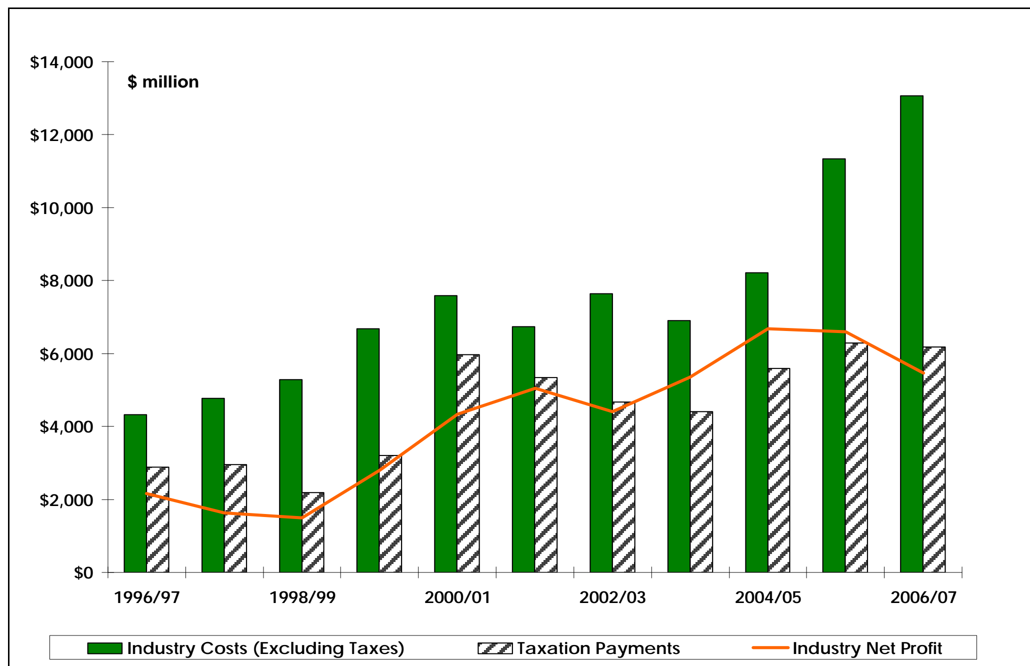
Recommendation 4: The Committee notes that the extension of crude oil excise represents an undermining of the economic efficiency and where excise is payable, gas producers may now require higher prices on gas sales to underpin or support project economics.

3.4 Perceptions of Industry Profitability

Comments or suggestions that petroleum projects are now generating windfall or above normal returns due to higher commodity prices (which therefore justifies the imposition of new or higher fiscal charges) fails to recognize a number of important factors.

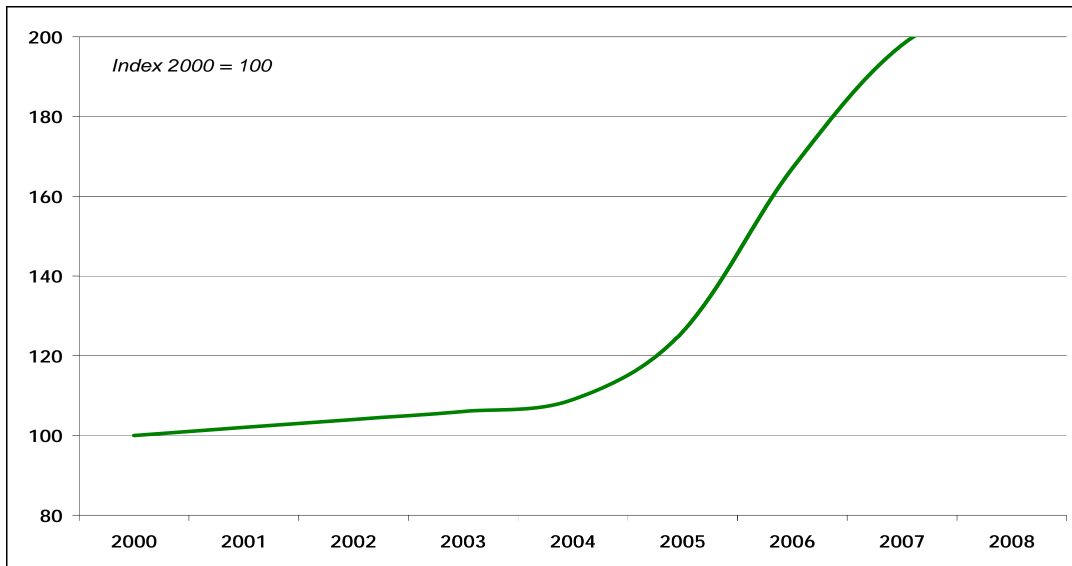
The recent strength in commodity prices has coincided with a period of rapid cost growth. Annual financial data compiled by APPEA highlights the unprecedented increase in industry costs over the last four years, while industry profits have remained relatively flat. Chart 2 highlights the key movements

Chart 2: Industry Financial Performance (Source: APPEA Financial Survey)



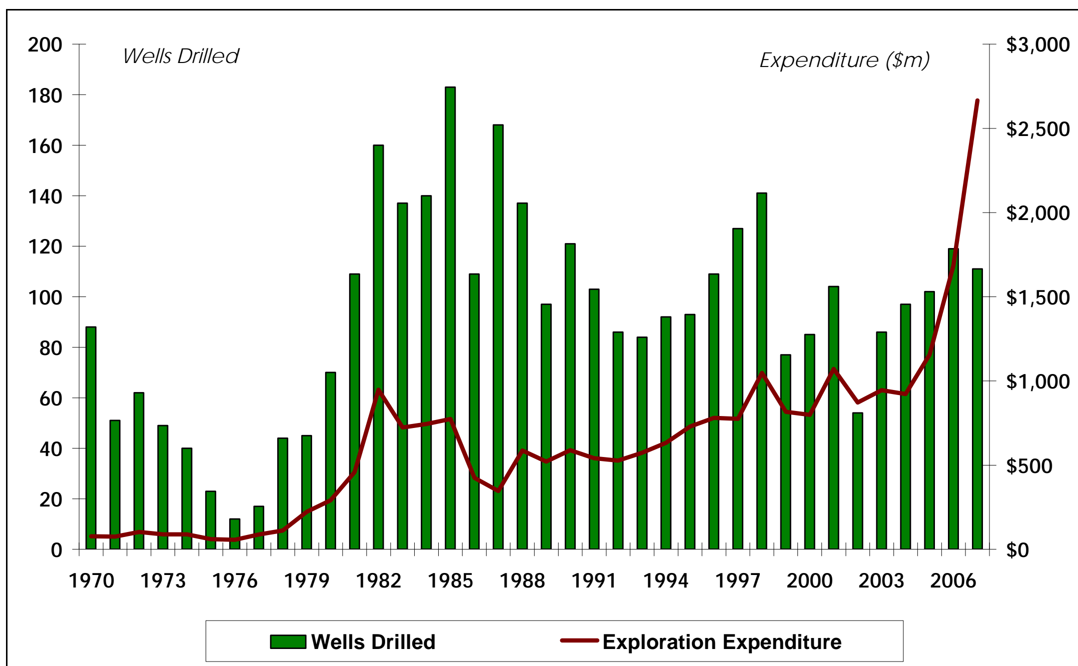
Cambridge Energy Research Associates (CERA) compiles an index of upstream industry capital costs. Dramatic growth has been recorded in the period 2004 to 2007 (see Chart 3). This confirms the trends recorded in the APPEA growth in industry costs highlighted in the APPEA data set.

Chart 3: Upstream Capital Cost Index (Source: CERA)



There has also been a significant rise in the level of exploration expenditure recorded over the last three years. The growth has been necessary to maintain drilling activity at previous levels. This again confirms the cost challenges confronting the sector; and

Chart 4: Petroleum Exploration Activity and Expenditure (Source: APPEA/ABS)



In a historical context, successive governments have generally not responded with reduced taxation burdens when project economics have been challenged due to lower commodity prices or rising input costs.

Recommendation 5: The Committee notes that rapidly escalating cost pressures confronting the industry are constraining growth in profits.

3.5 Heightened Perception of 'Sovereign Risk'

Sovereign risk is an important element in investment decisions by petroleum explorers and producers in distinguishing between jurisdictions competing for the development of petroleum resources, including the risk of change to fiscal systems. Many jurisdictions need to enter into fiscal stability agreements to guarantee fiscal terms for the life of projects because of sovereign risk issues. It is easy to dismiss Australia's sovereign risk as internationally competitive, without proper regard to regular changes introduced in annual Budgets.

The decision has the potential to heighten the perception that large scale investments in Australia may be adversely effected by fundamental changes to the policy framework. While the incidence of the decision may appear on the surface 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.

Australia must compete in an increasingly competitive environment for global funds and our perceived advantages in important areas such sovereign risk are threatened when significant modifications are made to key parameters, such as tax settings.

Recommendation 6: The Committee notes that adverse changes to fiscal settings following the completion of investment decisions can negatively influence investors' perceptions of Australia's sovereign risk and diminish its ability to attract further investment and supports the inclusion of petroleum specific issues in the Government's announced review of the Australian Taxation System.