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Review of the Petroleum Resource Rent Tax

Submission

Despite huge increases in gas production, revenue derived from the exploitation of our resources is declining. Current arrangements around the PRRT are distorting investment and failing to deliver benefits to the Australian community.

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INTRODUCTION

The Australia Institute welcomes the opportunity to make a submission to Treasury's Review of the Petroleum Resource Rent Tax (PRRT). The review occurs at a time when Australia is set to become the world's largest gas exporter, yet PRRT revenues are declining. Several major gas projects are unlikely to pay PRRT for decades, according to many analysts, including analysis commissioned by the industry lobby group, APPEA.[1]

The review aims to provide advice on whether the PRRT is operating "as intended". In the current situation with projects unlikely to pay PRRT for many years if ever, either there is no economic rent to be taxed, or the tax is not working as intended.

It is unlikely that multinational gas companies would invest billions in Australian gas projects that would yield no economic rent for decades. Even if this were the case, some of these projects operating in Commonwealth waters pay no royalties for the gas they extract. In other words, they receive gas without paying anything to its owners, the public. These projects that provide no economic rent despite free access to the public's gas resource would fail a cost benefit analysis, returning a negative net present value.

Furthermore, many gas projects benefit from subsidised infrastructure from state governments. As noted by WA Treasury, the North West Shelf project benefited from $8 billion in taxpayer-funded assistance:

> *In 2010 net present value terms, the cost of Western Australia's assistance to the North West Shelf project (e.g. payment of subsidies to the State's power utility to help cover the losses it initially incurred under crucial 'take or pay' gas contracts) is estimated to be around $8 billion.*[2]

Projects that deliver no economic rent, pay no PRRT, no royalties and receive subsidised infrastructure and other assistance are not the 'marginal project' that the PRRT aims to facilitate. They are sub-marginal, reduce the welfare of the Australian public and should not be pursued. In such cases it appears the current system works to distort investment and incentivise sub-marginal projects.

[1] Wood Mackenzie (2017) *Independent Report on the PRRT Review in Australia*, http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/Reviews%20and%20Inquiries/2016/Review%20of%20Petroleum%20Resource%20Rent%20Tax/Submissions/PDF/Australian%20Petroleum%20Production%20and%20Exploration%20Association%20APPEA.ashx

[2] WA Treasury (2011) *GST Distribution Review WA Submission*, p13, http://www.gstdistributionreview.gov.au/content/submissions/downloads/interim_reports/WA-Submission.pdf

Far more likely, however, is the possibility that the current system is simply failing to capture the economic rents that major gas projects deliver to their owners. Several key flaws that allow this to occur are outlined below.

UPLIFT FACTOR

The uplift factor applying to the PRRT is 15 per cent plus the long-term bond rate. As the Parliamentary Budget Office has recently reported, six per cent is the appropriate figure for the Government's assumed long-term cost of borrowing. That means an expected uplift factor into the future of 21 per cent. At that rate the value of any deductions doubles every 3.6 years and in ten years will increase 6.7 times.

The PRRT does not need such a high uplift factor. Industry proponents claim this is necessary to compensate for the risk of hydrocarbon exploration. However this argument is overstated. Exploration like many other 'investments' behaves like an 'S' shaped function over time; it starts off very small, increases rapidly and then levels off until the 'investment' is complete.

Real options theory explains that and we can see it intuitively. Small initial expenditures are made so as to be able to estimate the option value of committing further funds into the venture. Having made an initial assessment the decision is to shelve the project or continue further. As further steps are made and if the assessments are further suggestive of a good viable project in the future then further definition of the deposit is made. In this way the project is always able to be dropped but the decision to proceed at each step is subject to less and less risk. Hence for the exploration of a prospective operation, the risk of the first dollar of exploration spending may be very high but the last dollar of exploration spending is much less risky. Towards the end the exploration spending is more likely to involve working out the best way of exploiting the resource.

The industry focuses its lobbying on the early speculative exploration spending, but the reality is that much exploration spending is not high-risk. For that reason the uplift factor should be the same as for other expenses. The bond rate plus five per cent is too generous and should be subject to a cap of perhaps nine per cent.

Recommendation: The uplift factor be replaced by a common rate.

PROJECT LEVEL

The fact that exploration and other spending can be offset against other projects adds a serious distortion to the market. That means an entity with a profitable project that actually pays the PRRT has a greater incentive to explore new fields than a company without such a project/s. The taxable unit for the PRRT should be limited to the project in question and not transferable to unrelated projects.

Recommendation: The PRRT should continue to be imposed at the project (or production licence area) level and exploration deductions and uplift not applied to other projects.

PRRT AND OTHER TAXES AND CHARGES.

The PRRT is sometimes presented as an alternative to royalties and other charges on mining companies. However, the two are levied for entirely different reasons. Royalties are akin to a sale of the commodity in question and may well be tailored to recover government costs, much the same as a road usage and congestion charge reflects similar costs to the community. Where projects are not currently subject to a royalty, not only is the community not deriving a benefit from the exploitation of its resource, but this makes competition between gas producers unfair for those paying a royalty.

The PRRT by contrast is designed to capture for the community the super profits attributable to the uniquely favourable character of a particular deposit. Nevertheless any other levies would be a legitimate deduction against any PRRT liability.

Recommendation: The PRRT should operate in conjunction with other tax arrangements that may be imposed for other reasons.

THE PRRT RATE

Once the operator's reasonable costs (including the going rate of return) are covered, any additional revenue is unnecessary to attract the operator and so can be taken by the government without affecting the incentive to operate that project. In principle all the super profit should be returned to the people who own the superior resource. If we acknowledge that the PRRT is a mechanism for recovering the benefit of the

resource for the community then it is unnecessary to share over half of the super profit with the operator. However, just enough has to be left with the operator so there remains some incentive to operate efficiently. Experience in countries like Norway suggests the total tax on profits can approach 90 per cent without deterring investment. Australia could well implement a two tier arrangement with the rate increasing after (say) twice the uplifted capital value has been recouped.

Recommendation: The current 40 per cent PRRT should be increased to 70 per cent on projects that have earned double the uplifted value of their capital outlays.

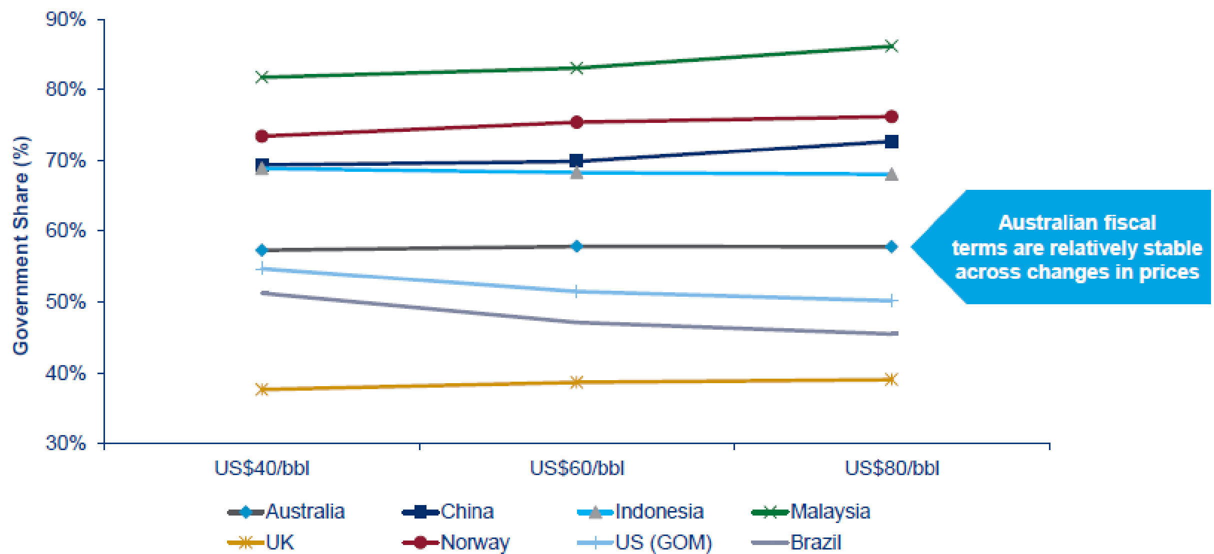
OVERSEAS COMPARISON

Unlike the current campaign by the federal government and business community to lower company tax, we rarely see the petroleum industry compare Australia's tax regime for oil and gas with the rest of the world. The reason is that most other countries with hydrocarbon deposits have ownership vested in the State and require joint ventures, partnerships, production sharing and other arrangements to be made with the relevant government/s or state-owned oil companies. The implied company/PRRT equivalent overseas is often very many times the Australian rate.

For example, in the UAE the general company tax rate is zero but is 50 per cent in the case of companies in the oil and gas sectors. Norway imposes a 78 per cent tax on super profits in the petroleum sector, a figure that does not include royalties, production/profit sharing and other arrangements, as noted in APPEA's submission to this review and the Henry Tax review.[3] In fact, APPEA's submission includes analysis that confirms that Australia's arrangements provide little return to government relative to other countries, reproduced in Figure 1 below:

[3] Wood Mackenzie (2017) *Independent Report on the PRRT Review in Australia*, p31.

Figure 1: International comparison of government share of oil project benefits



Source: Wood Mackenzie (2017) *Independent Report on the PRRT Review in Australia, p33,* report commissioned by APPEA.

Figure 1 shows that countries well known for oil and gas extraction such as Malaysia and Norway derive far greater shares of project benefits than Australia, yet have no trouble attracting investment in their oil and gas sector.

CONCLUSION

At best, Australia's arrangements for royalty collection and taxation of our oil and gas resources are encouraging sub-economic projects to be developed. More likely, the Australian public is losing billions in revenue, reducing our economic welfare and standards of living.

This review is timely and can help to address this situatio by recommending a reduction in the uplift factor, elimination of transferability of uplift, imposing a royalty on all oil and gas extraction and increasing the rate of the PRRT. This would see Australians share the benefits of their resources to a similar extent as already occurs in countries like Indonesia, Norway and Malaysia.