

WESTERN AUSTRALIA'S SUBMISSION TO THE REVIEW OF THE PETROLEUM RESOURCE RENT TAX

Key Points

- The current royalty revenue sharing arrangements between the State and the Commonwealth reflect both the State's significant investment in support of petroleum projects and historic royalty arrangements.
- The royalty sharing arrangements are also critical for ensuring an appropriate return to the Western Australian community from the recovery of petroleum resources.
- Ad valorem wellhead royalties provide a simpler, more stable and predictable revenue stream than profit (or rent) based taxes. They also have lower compliance costs for businesses and have the advantage of providing revenue up-front rather than potentially many years after mining has commenced. This makes ad valorem royalties a better revenue source than profit-based royalties for funding State infrastructure spending needs.
- The North West Shelf project royalty revenue verification processes used by the Western Australian Department of Mines and Petroleum are robust and adequate. The Australian people can be confident that North West Shelf project royalties are being accurately assessed and collected.
- The Western Australian Government requests that it is consulted about any potential changes to existing royalty arrangements, and also seeks a share of the Petroleum Resource Rent Tax and assurances that Western Australia's revenue from royalty sharing arrangements will not be adversely impacted.

BACKGROUND

On 30 November 2016, the Commonwealth Government announced a review into the operation of the Petroleum Resource Rent Tax (PRRT), crude oil excise and associated Commonwealth royalties. The review will report to the Commonwealth Government with recommendations by April 2017.

The review is focused around the following terms of reference:

1. The review will have regard to the need to provide an appropriate return to the community on Australia's finite oil and gas resources while supporting the development of those resources, including industry exploration, investment and growth.
2. The review will examine the design and operation of the PRRT, crude oil excise and associated Commonwealth royalties that apply to the onshore and offshore oil and gas industry, having regard to economic conditions in the industry and trends over time.
3. The review will also consider the impact of previous policy decisions on Commonwealth revenue.
4. Drawing on international experience, the review will make recommendations to the Government on future tax and royalty arrangements having regard to revenue adequacy, efficiency, equity, complexity, regulatory costs and the impact on the industry generally.
5. The review will also examine other related matters.

An Issues Note was released by the Commonwealth Government on 20 December 2016 seeking submissions by 3 February 2017.

INTRODUCTION

Western Australia's submission to this review into the operation of the PRRT, crude oil excise and associated Commonwealth royalties is primarily focused on the adequacy of royalty revenue from Western Australian petroleum projects and royalty sharing arrangements with Western Australia for the North West Shelf project, Barrow Island project and coastal waters.

This submission also responds to discussion in the Issues Note on the appropriate form and administration of petroleum royalties.

HISTORY OF INVESTMENT

Western Australia is Australia's major oil and gas producer.

Despite significant falls in oil prices between 2014-15 and 2015-16, Western Australia's petroleum sector was worth \$18.4 billion in 2015-16 and petroleum production accounted for 21% of the value of mineral and petroleum sales in Western Australia (second only to iron ore).¹

Of note, approximately 91% of Australia's remaining conventional gas resources are located off the north-west coast of Western Australia in the Carnarvon, Browse and Bonaparte basins.²

The Western Australian Government is committed to supporting the responsible and sustainable growth and development of the petroleum sector. The State has made significant investments in planning, developing and supporting petroleum projects and hydrocarbon processing precincts. This includes investment for the Ashburton North Strategic Industrial Area, the Browse LNG precinct and the Pluto and Wheatstone projects.

The Western Australian Government also aims to develop sustainable, attractive and affordable towns to encourage settlement (and economic activity) on a permanent basis. This investment is integral to the projects that are in and around the Pilbara, including the North West Shelf and Wheatstone projects, and the Barrow Island project.

Royalties from petroleum projects underpin the Western Australian Government's long term commitment to developing the State's regional areas into sustainable and strong economies. For example, Western Australia directs 25%³ of its mining royalties to its Royalties for Regions Fund (which holds up to \$1 billion per annum) for projects in regional areas.

Since December 2008, the program has invested \$6.9 billion⁴ of the State's mineral and onshore petroleum royalties to more than 3,700 projects across regional Western Australia.

Funding channelled into infrastructure in the Pilbara includes:

- The Pilbara Cities initiative (\$1.6 billion), to help develop Karratha and Port Hedland into better service centres to facilitate the development of industry and ensure a more balanced and sustainable economy and community; and

¹ Department of Mines and Petroleum, http://www.dmp.wa.gov.au/Documents/About-Us-Careers/Stats_Digest_2015-16.pdf

² Geoscience Australia, *Figure Gas Summary: Location of Australia's remaining gas resources as at 2014 end*. https://d28rz98at9flks.cloudfront.net/101061/2016_AERA_data_tables-Gas_chapter.xlsx

³ Excludes North West Shelf grants.

⁴ Department of Regional Development <http://www.drd.wa.gov.au/rfr/Pages/default.aspx>

- The Pilbara workers' housing initiative (\$240 million⁵), to relieve housing cost pressures on those workers not directly involved in the mining industry.

The State Government also funds other investment in the Pilbara region that is outside the Royalties for Regions program.

State Government agencies provide dedicated project facilitation services to these projects. Furthermore, the State Government is responsible for ensuring Western Australia's valuable oil and gas assets are managed safely and responsibly.

Without the commitment of the State Government, many of these projects may not be generating the revenue that they are today, or may not even exist.

For example, the Western Australian Government has played a key role in fostering the development of the North West Shelf project. This included favourable contractual arrangements and marketing support, major infrastructure investments and town site development and service costs.

North West Shelf Project

In the 1970s and 1980s the State played a pivotal role in securing the development of the North West Shelf project through agreements, financial assistance and infrastructure provision. This project helped to provide the impetus needed to develop other State resources and established Western Australia as a prospective location for natural gas development in the face of significant global competition. If the State had not made these investments, the project would likely not have succeeded.

The North West Shelf project proceeded in two major stages:

1. The domestic phase (North Rankin A offshore production platform and related infrastructure), which mainly involved the production of natural gas purchased by the (then) State Electricity Commission of Western Australia (SECWA) from 1985; and
2. The subsequent export phase, mainly involving the export of LNG to Japan, initially from 1989.

The domestic phase was underpinned by 20-year 'take or pay' contracts, signed in September 1980, between the Project Joint Venturers and SECWA for the supply of 414 terajoules per day of natural gas (commencing 1985) – the entire gas output from the domestic phase. These State guarantees were essential in ensuring the financial robustness of the North West Shelf project and were key to securing contracts with Japanese utilities for the export phase.⁶

⁵ Figure includes whole of Western Australia however primarily relates to the Pilbara Region. <http://www.drd.wa.gov.au/projects/Housing/Pages/Affordable-Housing-for-Workers.aspx>

⁶ Clements K and Greig R, 1991. *The Economic Impact of Australia's North West Shelf Project*, Discussion Papers 91.15 and 91.16. Economic Research Centre, Department of Economics, The University of Western Australia, September, p10.

In the following years, it became clear that contractual arrangements would need to be modified to avoid a financial collapse by SECWA and a stalling of the development of the North West Shelf project.

In March 1985, the Commonwealth and State Governments and the Joint Venturers agreed to “share the pain” that was forecast to be borne by SECWA as a result of the contract.

- In return for SECWA agreeing to set aside price redetermination rights for five years, the Joint Venturers agreed to modifications of the pricing arrangements in the South West and to assist in marketing gas to the Pilbara region. These arrangements⁷ were forecast to provide a benefit for SECWA of \$305 million.
- The Commonwealth agreed to waive in favour of Western Australia (for on passing to SECWA) its share of royalties payable on the domestic gas phase of the project, with a forecast benefit of \$70 million over the 20 year life of the agreement.⁸
- The State Government agreed to provide an estimated \$245 million in assistance to SECWA, comprising domestic gas phase royalties with an estimated value of \$145 million and a further \$100 million from its existing levy on SECWA gas operations.

The overall benefit to SECWA was estimated at the time to be \$620 million.

Despite this, SECWA was still forecast to incur annual deficits of around \$50 million over the period 1985-86 to 1997-98 on its North West Shelf gas operations, before breaking even in 1998-99.

State Government support for this project also included the construction by SECWA of the Dampier to Bunbury gas pipeline at a cost of around \$1.1 billion, to enable SECWA to deliver gas to the major markets in the South West.⁹

Altogether, the State’s expenditure in support of the North West Shelf project was calculated in 2010 by the Western Australian Treasury to exceed \$8 billion (in 2010 net present value terms).

In addition, the Western Australian Government incurred costs relating to town site development, schools, hospitals, community facilities and roads that were either directly associated with the project or arising from the economic and population growth accompanying the project. These costs have never been officially aggregated.

⁷ Including some changes agreed by Alcoa, a major gas customer of SECWA in the South West.

⁸ On 30 June 2000, the Commonwealth paid Western Australia \$79.1 million to settle its remaining ‘share the pain’ liabilities. This move was initiated by the State with the intention of eliminating the large costs of administering the payments by both levels of government that would have otherwise continued until 2004-05. The figure of \$79.1 million represents the agreed net present value of the estimated future Commonwealth share of DOMGAS royalties.

⁹ In March 1998, the Dampier Bunbury pipeline was sold to Epic Energy for \$2.407 billion, which was below the depreciated ‘risk free’ present value in 1998 terms of the construction cost.

CURRENT ROYALTY SHARING ARRANGEMENTS

Western Australia currently shares with the Commonwealth royalties from petroleum projects located in the State's coastal waters, and the North West Shelf project located in Commonwealth offshore waters.

The royalty revenue sharing arrangements between the State and the Commonwealth reflect both the State's significant investment in support of these projects and historic royalty arrangements.

Given the constitutional uncertainty over rights to petroleum in offshore areas, in 1962 preliminary discussions began between States¹⁰ and the Commonwealth.

In 1967, the Commonwealth and States agreed royalty sharing arrangements which specified¹¹ that a State would receive 60% of royalties paid on primary production licenses for offshore areas, and 68% of royalties from secondary production licenses for offshore areas (issued to fields with substantial reserves, such as the North West Shelf). These arrangements aimed to provide States greater financial dependence and in part address the apparent imbalances that exist between the States' and Commonwealth's revenue raising capacity.

In 1975, the High Court determined that the Commonwealth has sole jurisdiction from the low water mark to the limit of Australia's legal continental shelf.¹² However, despite this High Court ruling, the Commonwealth Government opted to maintain the States' rights to waters within the three mile limit¹³, reflecting that it considered States were better able to administer the thousands of small vessels and moorings, and numerous recreational boating activities, that would otherwise come under Commonwealth jurisdiction.¹⁴

The Commonwealth Government also opted to retain the royalty sharing arrangements established under the *Petroleum (Submerged Lands) Act 1967*.

Under the 1979 Offshore Constitutional Settlement between the Commonwealth and all the States, the Commonwealth agreed to share royalties from offshore petroleum projects with the States, again agreed on the basis established in 1967.

The following royalty sharing arrangements currently apply between the Western Australian and Commonwealth Governments.

¹⁰ In this submission, 'States' refers to all States and Territories.

¹¹ Eventually implemented through *Commonwealth and State Petroleum (Submerged Lands) Acts* in 1973.

¹² *New South Wales v. Commonwealth* (1976) 135 CLR 337.

¹³ At the time, the three mile limit was referred to as 'territorial waters' as it was the then width of the Australian territorial sea. The territorial sea now extends up to 12 nautical miles from the low water mark and areas up to three nautical miles from the territorial sea baseline are now termed 'coastal waters'.

¹⁴ White, Michael, *Australia's Offshore Legal Jurisdiction – History & Development*, p8.
<http://www.austlii.edu.au/au/journals/ANZMarLawJI/2011/3.pdf>

Projects within the Coastal Waters

- The coastal waters generally reflect the area up to three nautical miles from land¹⁵, as well as certain subsisting permit areas located within State inland waters, and are subject to 'onshore' State royalties.
- The Commonwealth receives 40% of State ad valorem petroleum royalties from projects in the coastal waters with a lease before 1979 (with the State retaining the remaining 60%).
- Western Australia retains 100% of State petroleum royalties from projects in coastal waters with a lease issued in or after 1979.
- The Western Australian Government is responsible for the administration of these royalties.
- In 2015-16, Western Australia collected approximately \$4.6 million in royalties from coastal waters and the Barrow Island project.

The North West Shelf Project

- Prior to the introduction of the PRRT in 1988, an ad valorem wellhead royalty and Commonwealth excise system operated in Commonwealth offshore areas, with the royalties shared between the Commonwealth and the State.
- At the time, only the Bass Strait and the North West Shelf project existed in the Commonwealth offshore area. The PRRT legislation specifically exempted these projects since they were already operational and subject to the royalty and excise regime.
- The State's entitlement to royalty revenue arises from the Offshore Constitutional Settlement under which the Commonwealth agreed to share all royalties from petroleum projects with the States.
- The Commonwealth is responsible for the collection of these royalties because it has jurisdiction over offshore areas. However, under the Offshore Petroleum (Royalty) Act 2006, the royalties are assessed and collected on behalf of the Commonwealth by the Western Australian Department of Mines and Petroleum (DMP).
- Western Australia receives its share of the North West Shelf project royalties in the form of a Commonwealth grant, amounting to approximately \$645 million¹⁶ in 2015-16.

¹⁵ Using straight lines where the coast is deeply indented or fringed by islands.

¹⁶ Includes Commonwealth compensation for the removal of the exemption of condensate from crude oil excise.

The Barrow Island Project

- Barrow Island is an onshore project, so normally the State would receive all of the royalties (and the Commonwealth would levy excise).
- This had been the case until 1985. However, to ensure the viability of this project, these regimes were replaced with a Resource Rent Royalty under the *Barrow Island Royalty Variation Agreement Act 1985* as an incentive for the continued maintenance of the wells on Barrow Island to ensure optimal oil recovery. At the time it was considered the combined royalty regimes were threatening the shutdown of parts of the project.¹⁷
- Western Australia receives 25% of the Resource Rent Royalties collected from this project with the Commonwealth receiving the remaining 75%. The higher Commonwealth share reflects the larger proportion of Commonwealth entitlements under the prior royalty and excise regime.
- By agreement, Western Australia is responsible for the administration of the Resource Rent Royalty regime.

These royalty sharing arrangements provide a significant source of revenue for Western Australia. It is essential that this revenue stream continues in order to support the outcomes of the Offshore Constitutional Settlement and enable Western Australia to provide a solid foundation for the development of infrastructure and other support for these petroleum resource developments as well as other State services.

Western Australia's revenue benefits from petroleum resource driven investment growth, particularly for LNG projects, is otherwise limited. This reflects that the revenue from LNG projects such as Gorgon, Pluto and Wheatstone will be collected by the Commonwealth Government through its PRRT.

The PRRT was introduced by the Commonwealth with no provision for revenue sharing with the States despite the royalty revenue sharing that had been in place for petroleum projects in the Commonwealth offshore areas. The objections of the States resulted in discussions between the States and the Commonwealth over the sharing of PRRT revenues.

Despite protracted discussions on sharing PRRT revenue between the Commonwealth and the States, the Commonwealth unilaterally decided that the States had no entitlement to a share of the PRRT.

¹⁷ Department of Minerals and Energy, <http://www.business.murdoch.edu.au/harman/docs/royalties.doc>

Given that Western Australia did not receive a share of PRRT revenues, in the 2007 Commonwealth election the then Opposition Leader, the Hon Kevin Rudd, committed to establishing a Western Australian Infrastructure Fund, financed from PRRT revenues. The promise was for 25% of future PRRT revenue from the Gorgon and Pluto LNG projects (up to \$100 million per annum) to be paid into this Fund, quarantined from the GST distribution process. This revenue was intended to recognise the State's infrastructure demands in support of such projects. Unfortunately, this infrastructure fund did not eventuate, despite efforts by Western Australia to put a formal agreement in place to give effect to this commitment.

The Western Australian Government considers that the current royalty sharing arrangements are critical for ensuring an appropriate return to the community from the recovery of petroleum resources.

The State Government also continues to believe that PRRT revenues should be shared with the relevant States.

The royalty shares help provide recognition for significant investments made by the Western Australian Government relating to projects within the North West Shelf project, Barrow Island project and the coastal waters.

In this regard, the Commonwealth has made limited investments in support of these projects and has been reluctant to redress the unfair GST situation that greatly reduces the return on the Western Australian Government's investment.

In net present value terms, around 89% of Western Australia's revenues from these royalty sharing arrangements are effectively redistributed to other States through adjustments to States' GST shares. This is exacerbated by the Commonwealth's failure to fully reflect the associated costs to the State in these GST calculations, despite the substantial effort by the Western Australian Government to redress the situation.

Until this situation is addressed, it also means that any changes to royalty sharing arrangements with Western Australia have the potential to affect the revenue of all States, not just Western Australia's, and therefore the revenue capacity of all States to continue to deliver services required by the Australian community.

AD VALOREM VS PROFIT BASED ROYALTIES

The Issues Note discusses the design and operation of Commonwealth royalties but erroneously describes the current ad valorem wellhead royalty as an output royalty. The ad valorem wellhead royalty regime that applies is more efficient than output royalties because it deducts certain operating and capital costs.

Overall, the Western Australian Government is of the view that the ad valorem royalty regime strikes a reasonable balance between the often competing objectives of maximising economic efficiency, fairness, simplicity, and relative stability and predictability of revenue streams¹⁸. Further, and relative to a profit-based resource rent tax (which can delay the receipt of revenue for many years), the current royalty regime delivers revenue up-front with greater budget certainty. This is an important consideration as State Governments will often fund common user infrastructure (and supporting social infrastructure) to ensure potential projects get off the ground, in turn allowing greater profitability for the resource companies.

Ad valorem systems can be seen as economically efficient. There is no evidence in Western Australia that wellhead systems have discouraged investment in projects.

The administration of wellhead ad valorem systems is relatively efficient as they are widely used, have applied for many years and are well accepted by industry and government.

Wellhead ad valorem systems as used in Western Australia, with their limits on deductibility, will always provide a return to the community whenever production occurs. Hence they can be argued to be fairer than rent based systems, such as the PRRT, where a considerable number of marginal projects will not make any return to the community.

In an environment of heightened need for social acceptance of, and accountability in, resource development, the transparency in the design and structure of royalty systems takes on increased prominence.

The wellhead ad valorem system is very transparent. It is based on an historical commercial system which is fairly well understood – which is in stark contrast to the resource rent arrangements, where the economic rent concept is not well understood and verification is based on company information usually regarded as confidential.

More significant issues for resource project developers are the overall taxation system, access to quality mineral resources, infrastructure, low sovereign risk, access to a skilled workforce and stable government. In this regard, any extended focus on the appropriate form of petroleum resource taxation is likely to increase investor uncertainty.

¹⁸ Refer to the Western Australian Government's Mineral Royalty Rate Review <http://www.dmp.wa.gov.au/Investors/Royalties-information-16542.aspx>

AUSTRALIAN NATIONAL AUDIT OFFICE FINDINGS

The Issues Note also briefly mentions an Australian National Audit Office (ANAO) performance audit on the administration of North West Shelf project royalties by the Commonwealth Department of Industry, Innovation and Science (DIIS).

The audit report¹⁹ was tabled in the Commonwealth Parliament on 28 November 2016 and makes four recommendations to improve the DIIS's governance and administration of the North West Shelf project royalty processes.

The recommendations are directed at improving the documentation that supports the accountability and assurance frameworks, including clear articulation of the operational responsibilities of the Commonwealth and Western Australian governments. The DIIS has agreed with all four recommendations and will work with the Western Australian DMP to implement them.

The Western Australian Government notes that the DMP's royalty verification processes are robust and comprehensive, and include annual detailed reviews of sales revenues, deductions and production volumes as well as independent third party verification.

All Australians can be confident that North West Shelf project royalties are being accurately assessed and collected.

RECOMMENDATIONS

1. Continue with the current royalty sharing arrangements to help ensure an appropriate return for the Western Australian community and recognise the significant investment made by the Western Australian Government.
2. Continue to apply an ad valorem royalty system in preference to profit and rent based taxes in order to provide an appropriate, more stable and predictable revenue stream for State infrastructure investment.
3. Provide assurances that Western Australia's revenue from royalty sharing arrangements will not be adversely impacted.
4. Consult the Western Australian Government about any potential changes to existing royalty arrangements.
5. Introduce PRRT revenue sharing arrangements, consistent with the 2007 commitment to establish a Western Australian Infrastructure Fund.

¹⁹ Australian National Audit Office – *Collection of North West Shelf Royalty Revenue*
<https://www.anao.gov.au/work/performance-audit/collection-north-west-shelf-royalty-revenue>