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Budget Policy Division
Department of the Treasury
Langton Crescent
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RE: APPEA SUBMISSION FEDERAL BUDGET 2016-17

The Australian Petroleum Production & Exploration Association (APPEA) is the peak national body that represents companies engaged in oil and gas exploration and production operations in Australia. APPEA's members account for more than 95 per cent of Australia's oil and gas production, and the vast majority of petroleum exploration.

The oil and gas industry is an integral part of the Australian economy, including through:
- the supply of reliable and competitively priced energy;
- the investment of hundreds of billions of dollars of capital;
- the direct payment of billions of dollars in taxes and resource charges to governments;
- the direct employment of tens of thousands of Australians; and
- the generation of significant amounts of export earnings.

The significant recent growth in our industry is underpinned by Australia's position at the cusp of a major shift in the world's economic weight from west to east. Global growth has been driven by the rapid industrialisation of economies to our north. This has changed the dynamics of key international resource, product and capital markets.

The economic advance of our region is overwhelmingly positive for Australia. It plays to our comparative advantage as a secure and reliable energy exporter, our proximity to markets and being an open economy that encourages foreign investment.

As we continue to prosper from the global demand for gas, we must be reminded that each Australian project must compete against other international projects for investment from a limited pool of international funds for both exploration and production activities. Funding that is lost from the Australian oil and gas industry will not be spent in other parts of the Australian economy – it will be redirected to Australia's overseas competitors.

While the industry has committed to the development of a number of large scale gas projects over the last decade, the next generation of investments (and extensions to existing and committed projects) and a continued exploration effort will be heavily dependent on stable, competitive and certain policy settings.

A key challenge in achieving future growth in the industry is maintaining Australia's international competitiveness in the face of a changing global energy sector. A high-cost local environment, a complex domestic regulatory framework and the potential for other countries to capture market opportunities, will continue to make it challenging for Australia to capture the next wave of global investment in the industry. The potential rewards however are significant for the Australian economy.

An immediate challenge facing the industry is the downward pressure on commodity prices that impact on project economics. The implication of lower prices, and therefore the potential return on projects, is for companies to revisit exploration and project budgets. This can see a reduction in exploration activity or a deferral in projects decisions.

The industry is experienced in managing this scenario, however there are important actions that governments should initiate to improve the broader investment framework.

To that end, APPEA seeks to ensure that government policy settings:

- achieve timely and secure access to resources for exploration and development;
- facilitate access to capital through a regulatory framework that supports investment and industry productivity; and
- enable access to domestic and international markets on globally competitive terms without distortionary and interventionist policies.

Access to resources

Australia's offshore acreage and resource management system has provided a framework for the timely exploration of the nation's petroleum resources, and the subsequent development decisions that have seen Australia become a leader in the global gas market. Since the commencement of production from the Gippsland Basin in the mid-1960's, it is estimated that the industry has made direct taxation payments to the Federal Government of nearly $200 billion. This is in addition to the reliable and secure supply of competitively priced energy over many decades. It is critical that this not be threatened through unintended consequences arising from changes to the resource management framework that will undermine the operation of the current system.

APPEA welcomes the Government's continued commitment to the provision of high-quality, pre-competitive geoscience information that makes a significant contribution to the science and knowledge base underpinning Australia's successful resource industry[1]. Access to such information, combined with the long-standing and successful acreage release framework based on the work program bidding system has allowed Australia to become a reliable supplier of petroleum to both domestic and export markets. APPEA remains concerned about the use of cash-bidding for the release of any exploration acreage, including the potential complexities associated with both the bidding registration process and the continued use of a confidential reserve pricing system.

Australia's resource management regime must continue to be viewed as an integrated regime that encourages ongoing exploration, development and production activity. APPEA was an active participant in the Offshore Petroleum Resource Management Review[2]. Many of the recommendations contained in the report highlight the importance of a stable and whole of project life approach being adopted in the management of the nation's offshore petroleum resources.

APPEA is concerned with proposals by the National Offshore Petroleum Titles Administrator (NOPTA) to significantly increase the costs of industry regulation. The cost increases seem to be inconsistent with the level of industry activity and the cost challenges confronting the industry. We consider it essential for the regulator to manage its operating and capital budgets in a manner that is consistent with the framework that confronts the industry.

[1] Geoscience Australia points out that a $3m investment in pre-competitive geoscience in the Browse Basin is expected to deliver $72 billion of export revenue for Australia over the next 40 years. See: www.ga.gov.au/value-to-the-nation#s1
[2] See: www.industry.gov.au/resource/UpstreamPetroleum/Pages/Offshore-Petroleum-Resources-Management-Review.aspx.

Fiscal settings

A strong and growing oil and gas industry creates enduring wealth for the Australian community through economic growth, long-term employment and local contracts, and long-term revenue streams for governments.

The tax system plays a key role in influencing investment decisions in the Australian petroleum exploration and production industry and Australia's ability to compete for international investment funds. The immediate deductibility of exploration costs remains a cornerstone of the tax system for the resources sector, while the treatment of capital under the income tax regime has a significant impact on the decisions of companies to develop discovered resources. It is also important that the tax system supports the use of Australia's existing oil and gas infrastructure through provisions which encourage the efficient use of infrastructure assets to encourage future project developments, and that the cost of financing projects continues to be a recognised cost of undertaking economic activity.

APPEA and its member companies support genuine tax reform. The industry has been an active participant in numerous reviews of aspects of the fiscal system since the 1970's, and have taken a constructive and transparent position in examining reform options, including assessing the potential impact on investments in the industry.

APPEA has been actively engaged in recent tax reform debates, including the Federal Tax White Paper[3] process and House of Representatives Standing Committee on Economics *Inquiry into tax deductibility*[4]. It is critical that fiscal stability be maintained for often decade's long investments.

With the above in mind, the following recommendations are made in a broad fiscal context (noting that some require coordination with state/territory governments):

- The existing taxation treatment of exploration expenditure be fully retained. The provisions recognise the uncertainties associated with exploration and the outcomes of a succession of past reviews that have confirmed the appropriateness of the present treatment.
- The existing capital depreciation provisions (statutory effective life caps) as they apply to oil and gas assets be retained. Significant sums of company tax are already payable well before an investor is able to recoup their invested funds, while the depreciation provisions in Australia still do not compare favourably with those in other gas producing countries.
- The retention of the current thin capitalisation provisions for determining interest deductibility, recognising the significant challenges associated with introducing modified arrangements for capital intensive industries which are subject to significant fluctuations in product prices.
- Crude oil and condensate production excise be abolished for all onshore and state waters production areas, recognising that the petroleum resource rent tax is now the Federal Government's primary tool for resource taxation purposes.
- In order to reduce the Goods and Services Tax (GST) compliance burden and risks associated with transactions between joint venture participants, it is recommended that revenue neutral amendments be introduced to sub-division 51-B of the GST Act.
- Governments consider the harmonisation of the administration of the petroleum royalty regimes (and other imposts) in Australia and that measures be considered to provide royalty relief for the production of hydrocarbons from projects that require the adoption of new technologies.

[3] See: bettertax.gov.au.
[4] See: www.aph.gov.au/Parliamentary_Business/Committees/House/Economics/Tax_deductibility.

Energy policy

In all sectors of the economy – not just oil and gas — maintaining access to open and competitive markets is in Australia's best interest. Energy policy should in particular focus on efficient and competitive markets, increases in new energy sources to ease demand/supply constraints, regulatory reform and the need for removal of unnecessary barriers to continued investment in exploration and production.

As is noted above, Australia's upstream oil and gas industry is delivering substantial, economy-wide benefits in terms of investment, jobs, and regional development. For these benefits to be sustained, governments must continue to resist calls for policy interventions that force non-commercial outcomes.

Australia's gas supply industry remains focused on both its domestic and export markets, creating significant wealth for the country. APPEA notes the 2015 Energy White Paper (EWP) again rejected calls for inefficient, inappropriate and ineffective regulatory interventions, such as gas market reservation policies or so-called 'national interest' test and focused instead on market-based energy policies. Governments must continue to focus on removing regulatory and other barriers to allow more gas to flow into the market.

Australia will continue to produce a proportion of its liquids requirements from indigenous sources, however will rely on access to international markets for a growing proportion of its requirements. The key to Australia continuing to secure its important liquids requirements is through more local exploration and ongoing and open access to international markets.

APPEA does not support the allocation of a fuel reserve volume to meet energy security arrangements, as articulated in the recent EWP. Energy security is best achieved through: allowing market forces to drive the selection of choices by ensuring that the various forms of primary energy compete on an equitable basis; a tax and regulatory framework that is stable and consistent; minimising complexity of regulatory processes; promoting global participation both with respect to sourcing or exporting energy and allowing trade in technology; and an attractive environment for exploration in Australia.

Conclusion

Australia's upstream oil and gas industry remains committed to ongoing policy reforms that overcome the nation's high cost challenges and lead to more investment being secured to develop our abundant natural resources. To discuss any aspect of APPEA's submission, please contact Mr Damian Dwyer, Director – Economics at ddwyer@appea.com.au.

Yours sincerely

M. Roberts

Malcolm Roberts
Chief Executive

Appendix 1

THE ECONOMIC CONTRIBUTION OF AUSTRALIA'S OIL AND GAS INDUSTRY

Introduction

Since the late 1960's, oil and gas exploration and production has played a significant role in the Australian economy. The industry has been pivotal in the supply of energy to Australia and many of our key trading partners. The growth of the industry has provided many benefits to Australia.

The position of the industry today as an emerging global leader in the supply of natural gas to the world has to a large part been underpinned by the application of a range of important tax settings. These have assisted investors commit the vast sums of capital necessary to both find and develop the resource base. Importantly, they have generally created a stable framework that has provided investors with the confidence to respond to the competition challenges from other countries.

Changes to cost structures as a result of tax modifications can have significant implications in capital intensive projects with long lead times. Changes can negatively impact exploration and development decisions. While investments in the industry have been significant to date, future decisions will be dependent on a fiscal regime that balances risk with reward. To capture future opportunities, it is critical that the company tax regime remains structured in a manner that does not discourage investments in risk taking and value adding activities.

The National Economic Contribution of the Industry

The industry is approaching the end of a wave of new investments in gas projects that has led to one of the largest commitments of funds in Australia's history. Further investment in the oil and gas sector is within reach, however it is by no means assured.

A number of studies published over the past five years have confirmed the contribution that the industry will continue to make to Australia's prosperity. Below is a sample of the results.

National Economic Benefits (Deloitte Access Economics 2012)

In 2012, Deloitte Access Economics (DAE) undertook an economic study of the sector[5], quantifying the output and how it will potentially grow over time. DAE also analysed the economic impact of the industry, recognising the unprecedented level of capital investment committed and the value of increased production. This captures the industry's contribution over and above its significant production and export profile.

The analysis covers the economic contribution through the direct impact of oil and gas operations and the flow-on contribution of oil and gas projects. In 2011, the sector contributed $28.3 billion to the economy – accounting for 2.0% of GDP. The extractive processes and related refining operations are extremely capital intensive and value adding. Of this, $4.3 billion was found to be flow on contributions distributed among supplying industries: exploration support and professional services, maintenance and construction, transport and storage and wholesale trade in Australia. The linkages between sectors have significant regional, interstate and international dimensions.

[5] See www.appea.com.au/wp-content/uploads/2013/04/120625_DAEreportAPPEAfinal.pdf for more details.

While the existing economic contribution is substantial, the future contribution is expected to be even more significant. The committed expansion is forecast to increase output by $68 billion in 2020 and $63 billion in 2025. The share of the oil and gas industry and associated exploration activities to GDP increases from 2.1% to 2.5 % in 2025 – peaking at 3.5% in 2020. On the back of considerable expected production growth, the oil and gas industry is forecast to make a substantive contribution to government revenues – $93.6 billion in net present value terms (2011 dollars for the period 2011 to 2025). These projections are indicative only given the volatility of commodity prices and cost structures for individual projects. Over the period to 2025, GDP is expected to increase by just over $260 billion in NPV terms.

Australian Oil and Gas Industry Value-Adding (PwC 2014)

Australia's oil and gas industry has arguably underpinned much of Australia's economic prosperity and growth over the last decade. A 2014 PwC report[6], *Value Adding: Australian Oil and Gas Industry*, shows that:

- The oil and gas industry directly accounts for around 2 per cent of GDP, with value-added of about $32 billion in 2012-13.
- The contribution of the oil and gas and exploration sectors is projected to double to about $53 billion in 2019-20 and $67 billion in 2029-30.
- The annual value of natural gas exports is expected to be $60-70 billion by 2019.
- After accounting for its inter-linkages with the rest of the economy (businesses all over Australia supply goods and services to the oil and gas industry, and the use of fly-in, fly-out staff is spreading the benefits of the industry), the sector is projected to be around 3.5 per cent of national output in 2030.
- By 2020, the sector's economic contribution will more than double to $70 billion and taxation paid will rise from $8.8 billion in 2012 ($4.9 billion in corporate taxes and $3.8 billion in production taxes) to reach almost $13 billion.

The Queensland Coal Seam Gas Industry (ACIL Tasman 2014)

The potential benefits of the growth of Queensland's coal seam gas sector were evaluated by ACIL Tasman in 2012[7]. It was estimated that the expansion of the gas industry has the potential to increase Gross State Product in Queensland by half a trillion dollars in the coming decades, boosting employment, wages, and the state's reputation as an economic powerhouse. The industry's activities will be responsible for more than 20,000 full-time equivalent jobs each year by 2035.

The report also finds in the years 2015 to 2035, the expansion of the Queensland CSG industry could:

- Increase real Australian Gross Domestic Product by $516 billion;
- Place downward pressure on wholesale electricity prices, reducing prices by 10%;
- Pay a further $275 billion to governments in taxes and royalties; and,
- See Queensland real income rise by $342 billion, or $28,300 per person.

[6] See http://www.appea.com.au/wp-content/uploads/2014/11/PwC-Report-Oil-and-Gas-Industry-Sept-2014-FINAL.pdf for more details.
[7] See www.appea.com.au/wp-content/uploads/2013/05/120606_ACIL-qld-csg-final-report.pdf for more details.

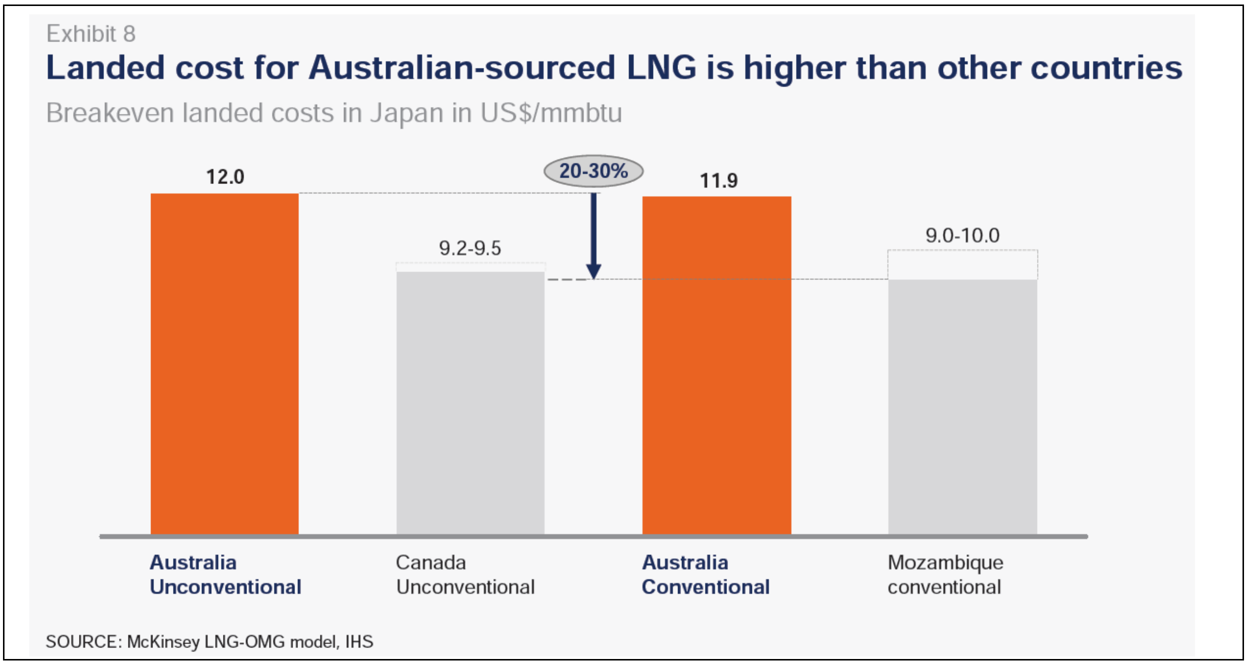
Industry Cost Challenges

In addition to the actual and potential benefits of the sector, there nevertheless remain a number of challenges that the sector must address if it is to realise the potential benefits.

Improving Competitiveness (McKinsey & Company 2013)

A report prepared in 2013 by McKinsey & Company[8] on extending the LNG boom in Australia highlighted the size of the potential prize for the country and the challenges of capturing that prize. In terms of costs, Australia faces significant challenges, being up to 30 per cent more costly to supply LNG compared with a number of potential competitor countries.

Chart 1.1: Australia's Cost Challenge – LNG



Source: McKinsey & Company (May 2013)

Transitioning from Construction to Production (Accenture 2015)

In 2015, Accenture examined the transition of investment in the Australian LNG industry from a construction to a production focus[9]. In addition to confirming the growth in GDP, demand for operational services and the overall expenditure in the operating phase of production, a detailed analysis was undertaken and a number of observations were made about the capabilities and challenges that confront the industry.

Accenture developed a Services Sector Readiness Index (SSRI) with a scale of 0 to 1.0 to measure the degree of confidence in the five key dimensions of readiness. While the views of stakeholder varied slightly across segments of the production and supply chain, there was general agreement about the readiness of the sector.

[8] See www.appea.com.au/wp-content/uploads/2013/07/Extending_LNG_boom_McKinsey.pdf for more information.
[9] See www.appea.com.au/2015/05/red-tape-industrial-relations-could-stifle-lng-potential for further details.

Overall, out of a maximum score of 1.0:

- Workforce capacity was rated at 0.58
- Workforce capability was rated at 0.68
- Competitiveness was rated at 0.37
- Regulatory framework was rated at 0.40
- Industrial relations framework was rated at 0.32.

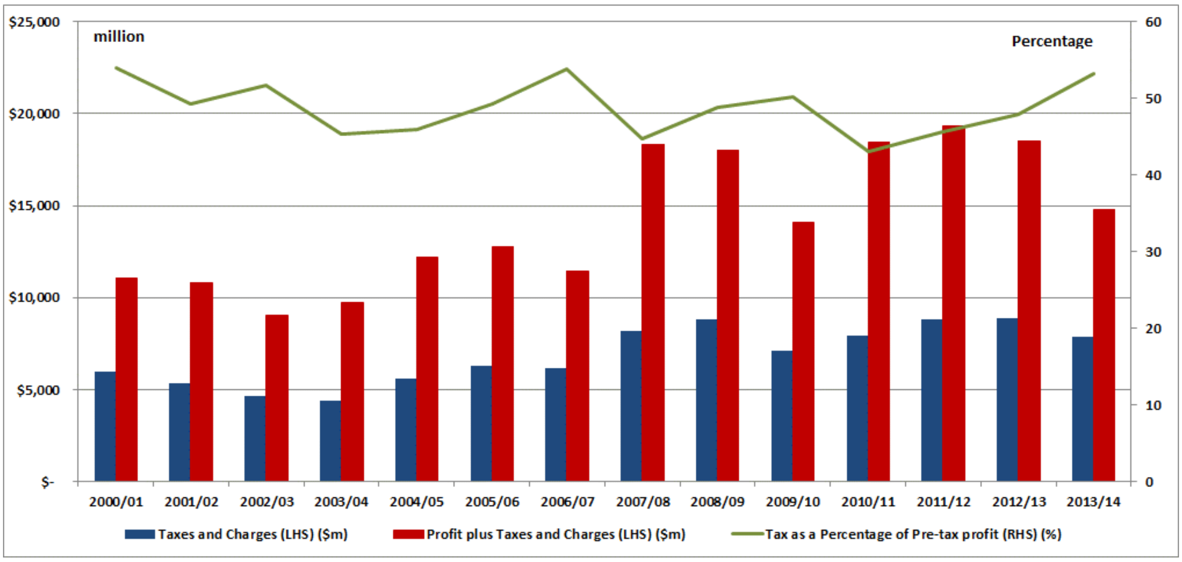
The results show confidence in capacity, given a relatively high level of workforce skills. Capability also rated highly, due to service providers optimising their operating models, investing in skills development and effectively using operational and information technologies. Efforts to improve capacity and capability would provide a workforce well suited to the demands of LNG operations and the development of a top quartile performance culture. However, the results show there is considerable room for improvement in competitiveness, regulation and industrial relations.

Industry Tax Contribution

The industry is confronted with a variety of taxes, charges and fees in relation to petroleum activities. These include resource taxes (including the petroleum resource rent tax, petroleum royalties and production excise), company income tax and numerous other taxes, fees and charges ranging from import duties to state based licence fees and duties.

Annual industry financial survey data compiled by APPEA indicates that, on average, taxes account for just under half of the industry's overall level of pre-tax profit. See Chart 1.2.

Chart 1.2: Estimated Petroleum Industry Profit (Before Tax) and Tax Payments



Source: APPEA Financial Survey

In terms of the segmentation of the two primary forms of taxation paid by the industry (company tax and resource taxes), total payments have averaged around $8 billion per year over the last five years, with company taxes estimated to account for slightly more than half of the total amount paid.