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What Have We Learned from the Australian Resource Taxation Experience?

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Background

In May 2010, the Australian Government announced the introduction of a 40% 'Resource Super Profits Tax' (RSPT) that would apply both to mining and mineral resources and to petroleum industry, with effect from 1 July 2012. The key target of the fiscal reform was the mining sector, not the petroleum sector. Nevertheless policy makers decided to include the latter within the scope of the new tax. Most offshore oil and gas activities have been subject to a similar tax - the 'Petroleum Resource Rent Tax' (PRRT). Some would have the option of transitioning to the RSPT regime or remaining under the PRRT regime. Other projects would have no such option including the currently producing North West shelf gas project which would be obliged to move from its current Tax and Excise duty regime to RSPT. The tax changes for this particular project would be the source of material near term revenues to the exchequer.

Overall the announcement created considerable uncertainty as to the future tax status of existing projects. Traditionally, Australia's concessionary petroleum fiscal regime involves two structures:

- i. For onshore activities, the following taxes apply: Excise Duty 30%, Royalty 12.5%, Corporate Income Tax (CIT) 30%, bringing the marginal tax rate to 57.2%
- ii. For offshore activities, the following taxes apply: Petroleum Resource Rent Tax (PRRT) 40%, CIT 30%, bringing the marginal tax rate to 58%

However, the proposed tax changes would have led to the possibility of three fiscal regimes running in parallel for decades to come, namely Tax and Excise, PRRT and RSPT. Added to that, the whole way in which the new tax was intended to be introduced, and the transition rules and pathway from the existing regime for those companies and projects shifting to the new to RSPT, remained poorly defined and left considerable uncertainty as to the overall economic impact. With hindsight, it has to be said that the proposed changes were poorly understood and researched prior to the announcement.

Unsurprisingly, angry reaction from the industry, particularly the mining industry, followed the surprise announcement. A month later, the Prime Minister (PM), Kevin Rudd, was ousted from

Editor's Note

By Douglas Townsend, ITIC Senior Advisor

ITIC serves as a neutral forum for discussion and resolution of fiscal problems, primarily in transition and developing countries; and acts as a clearing-house for information and as a training center for transferring 'best practice' taxation and investment 'know-how', in order to improve the investment climate.

ITIC concentrates both on intellectual production, such as independent research studies on specific areas of tax and investment prepared by experts from government, academia and industry; and on Know-How transfer, such as education and outreach programs, again involving government, academia and industry experts. Principles for fiscal regulation guiding such ITIC work include systemic simplicity, fairness, revenue adequacy, stability, encouragement of investment, partnership and non-discrimination.

Recent events in OECD Member Country Australia, long seen as a champion of balanced fiscal reform pursued through close consultation between the revenue authorities and the taxpayer, jolted the potential applicability of these principles to the attraction of investment to the minerals resources sector.

ITIC considered therefore that this seemingly-atypical event and the subsequent policy adjustment proposed by the Canberra authorities warranted closer investigation. Thus, ITIC invited the renowned energy fiscal authority, Dr. Carole Nakhle (see bio on page 3), to contribute this analysis of the Australian action and its wider implications for policy governing taxation of the minerals resources sector.

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within his own party as he became embroiled in the bitter political fallout from the tax increase, among other problems. In July 2010, the new PM, Julia Gillard, made new fiscal announcements, replacing the RSPT with a 'Mineral Resource Rent Tax' (MRRT), also effective from July 2012. On the surface, this appears significantly less severe than the RSPT for the mining sector. MRRT will apply at a rate of 30%, and only to iron ore and coal mining activities, while the 40% PRRT will be extended to include all onshore and offshore projects involving both oil and gas production, treating all oil and gas projects equally. The net result will be the simplicity of a single tax regime for the upstream sector based on PRRT. However this will still require the implementation of complex and as yet unclear transition rules for the North West shelf project.

PRRT was introduced in 1987, as an attempt to capture economic rents from offshore oil and gas operations. It applies once fields have achieved a certain rate of return and is deductible for CIT purposes. There is no stabilisation clause, as is the case in most OECD countries, and some minor changes have been introduced occasionally. But overall, it can be argued that PRRT has been a stable regime and performed well over a period in which there have been substantial changes in geological understanding and economic circumstances.

Investors have long praised Australia's fiscal stability. However, this advantageous position most probably has been negatively affected following the introduction of RSPT. The new Government has swiftly embarked on a damage limitation exercise. It remains to be judged what the long-term consequences are.

Unintended Consequences?

In examining the attractiveness of one oil or gas province against another, a prospective investor will weigh many factors. These include:

- Basin prospectivity (the chance of finding oil or gas)
- Volumetric potential (how large are the discoveries)
- Basin cost structure (overall finding, development and operating costs per barrels of oil equivalent)
- Access to infrastructure and opportunities
- Access to and proximity to markets.
- The fiscal regime—its competitiveness, evolution, complexity and stability
- Political stability

This is not a menu from which to choose; all these factors should be included.

Australia is one of the main countries long seen as an upstream investor friendly province. It has significant petroleum, natural gas and coal reserves and is close to key Asian markets. It is politically stable and offers investors relatively internationally competitive fiscal terms and low perceived fiscal risk. It is not surprising to see that even in times of financial uncertainty Australia has been viewed as a safe haven. There is no state

participation; Australia's oil and gas sectors are dominated by the industry's largest players. This latter point is important and to some extent a double edged sword. A state oil company which has a material equity position across the basin ensures that a large proportion of investment and investment decisions are captive to the state so the negative consequences of tax increases are likely to be far less damaging and diluted. But of course this does require a large drain on Government resources to fund the necessary investments. A basin wholly dependent on investment from international oil companies (IOC's), the norm in much of the OECD, is more vulnerable to the flight of investment as Australia has discovered.

Although gas is normally worth considerably less than oil in terms of value equivalence, particularly for LNG due to costs of liquefaction and transportation, Australia still managed to attract substantial investment in both the oil and gas (particularly LNG) sectors. This placed the country amongst the world's leading countries in terms of upstream investment. Australia is the world's fifth largest LNG exporter. The country managed to offer value and material returns to international investors by having an attractive stable fiscal regime, which restores the balance with respect to many oil and gas rich countries.

This benign picture, however, was put in jeopardy with the sudden proposed fiscal reforms, introduced in May 2010. The recent U-turn has probably sustained external confidence in the regime but only just. It may take some time for the perception of Australia's fiscal risk to return to the 'status quo ante'. The Australian experience is just another example of the familiar situation round the world where Governments assume a successful resource extraction industry simply represents a target for punitive taxation rather than the object of a competitive and stable fiscal regime. In the short term, Government can indeed raise more tax but it is dangerous to assume that the consequences will be minimal. Whilst natural resources cannot leave the country, the investment that is required to extract it certainly can. This is the fundamental misjudgement made by the Australian authorities. The very real threats made to cancel and review projects across the mineral resources sector ultimately made the Government realise that the consequences had been underestimated, risking long term damage to investment, employment and tax revenues if not ameliorated.

Fiscal regimes are, of course, not expected to be set in stone. Circumstances are constantly changing in any basin. Yet fiscal changes, particularly increases in taxes driven by short-term focus on generating additional revenues without taking into consideration the wider picture, can create adverse consequences.

Oil and gas projects are long term endeavours; they have inherent levels of risk present at every stage - from exploration to abandonment. If the variation of taxes over project life can be minimized - that is if the tax regime is stable - one risk factor is either reduced or eliminated. If fiscal stability cannot be constitutionally guaranteed, then investors have to live with the fiscal risk. However, this can be acceptable provided that the fiscal risk is compensated for by a lower level of Government take, and provided that where tax increases occur they are perceived to be balanced, thoroughly researched, follow appropriate consultation and are not retroactive.

Stability of the fiscal regime is not only important for investors; it is equally important to governments. A tax system that has some level of predictability and reliability enables governments to know how much revenue will be collected and when. Stable government revenue clearly assists with reliable expenditure forecasting and budgeting.

If a Government increases tax simply on the basis of rising oil prices, in theory and in an ideal policy environment it should reverse the increase in tax rate when oil prices fall. But of course it never does and there is always a floor to taxation. Besides, while oil prices have recently increased, gas prices have gone in the other direction. So building tax policy on oil prices increasingly ignores the needs of gas production, particularly so when gas is the dominant resource.

Additional risks have recently emerged, creating further uncertainty to international upstream investors.

Following the oil spill in the Gulf of Mexico, tighter regulations are expected particularly on offshore activities, most likely leading to project delays and higher costs. International oil and gas investors have now to reassess both their risk exposure and portfolio, in the light of such structural developments. Investors have limited resources and they seek to allocate them in the most efficient way, especially in today's tough financial environment where those resources are constrained. IOC's capital will flow to the most attractive opportunities in their global portfolio, where the optimal balance between risk and reward can be achieved.

The climate change agenda is also still unclear, but most signs point in one direction: towards a much more challenging environment for oil and gas investors, whether through tighter regulations, carbon permits or/and carbon taxes, to name few.

Conclusion

The legacy of the global financial crisis has left many Governments desperately searching for new sources of revenues. The resources sector is an obvious target, indeed the IMF has recommended that nations examine whether more rent can be extracted. However this is only practical if the revenue can be extracted without damaging investment and confidence, hence pointing to modest change rather than penal. Clearly, the conditions are not as favourable for challenging existing fiscal terms as many policy makers had assumed.

Some Governments have already tried to seize the opportunity created by the temptation of other Governments to tighten their fiscal terms. Canadian policy makers, for instance, have used Australia's proposed SPRT to entice foreign investment to their country, by lowering their taxes, rightly believing that higher taxes do not necessarily mean higher revenues, particularly if they lead to a loss in investment, revenues and profits.

Of course, being the sovereign owner of the resources in the ground, Governments are free to decide how to manage their sectors. Many Governments, however, fall into the trap of copying other countries' measures, arguing that 'others have done it, therefore we should follow'. But there are serious shortcomings to this approach. What works in one country does not necessarily work in another. Fiscal regimes should be, in

principle, tailored to the relevant oil and gas province realities. What happens in reality depends on Government's objectives and desires.

Australia has discovered the limits to resource taxation. The visible U-turn has now resulted in less tax for the host Government than arguably could have been raised if their initial tax raising ambitions had been more tailored to the industry's realities and had been grounded in a clear dialogue with the industry. Taxation needs not be a win-lose game. Well crafted tax regimes can benefit both tax taker and taxpayer. In the Australian case this clearly did not happen.

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From 2005 to 2008, she served as Senior Research Fellow in Energy at the University of Surrey. Over the same period, she also acted as Special Parliamentary Adviser on Energy Issues and Middle Eastern Affairs in the House of Lords, UK.

She is the director of 'Women in Energy' and she is Global Senior Advisor to Asia-Pacific CEO Association Worldwide, and a Program Advisor to the International Tax and Investment Center.

Dr. Nakhle has published two books. The first, "Out of the Energy Labyrinth", is co-authored with Lord Howell, the former UK Energy Secretary and currently Minister of State in the Foreign and Commonwealth Office, UK. The book shows how the search for safe global energy supplies can work in harness, instead of in conflict, with the struggle to curb greenhouse gases and climate change. The book is available in English, Japanese, Arabic and Turkish. Her second book, entitled "Petroleum Taxation: Sharing the Wealth", takes the reader step-by-step through the entire petroleum taxation story.

Dr. Nakhle has also written a report, in both English and Arabic, at the request of the International Tax and Investment Centre in Washington, on the contractual framework for oil and gas investment in Iraq. The aim of the study is to assist in providing Iraqi policy makers with an objective assessment of the potential contractual frameworks that could be created.

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