2020-21 FEDERAL PRE-BUDGET SUBMISSION

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INTRODUCTION AND RECOMMENDATIONS

The Australian Petroleum Production & Exploration Association (APPEA) is the peak national body representing upstream oil and gas explorers and producers active in Australia. APPEA's member companies account for more than 90 per cent of Australia's petroleum production. Further information about APPEA can be found on our website, at www.appea.com.au.

Reliable energy supply is essential to economic development. APPEA works with Australian governments to help promote the development of the nation's oil and gas resources in a manner that maximises the return to the Australian community and industry. APPEA aims to secure regulatory and commercial conditions that enable member companies to operate safely, sustainably and profitably because the industry takes very seriously, its responsibility to continue to power Australian homes, businesses, hospitals, schools and other industries.

As the Australian and global economies recover from the impact of COVID-19 global pandemic, it will be critical that Australia is able to attract business investment needed to support economic development. The regulatory settings will need to position Australia as stable, prospective and lower risk investment destination by providing a competitive and stable fiscal and regulatory environment, by enacting significant reforms. It is not possible to tax our way back to growth.

The following recommendations which can be actioned in the 2020-21 Federal Budget, will go some way in achieving this goal and ultimately help secure the next wave of global investment in Australia. This can be achieved without compromising government revenues and the integrity and the underlying principles of Australia's taxation regimes.

1. ***Encourage employment and job creation by making salary and wage costs immediately deductible for all capital intensive industries like infrastructure, mining, utilities distribution and transmission, agriculture, construction and oil and gas.***

2. ***Introduce investment allowance(s) to provide positive signals and encourage investment, promote domestic spending and increase employment opportunities.***

3. ***Remove barriers to business project restructuring by reforming the rules around transactions involving swaps of permits and existing infrastructure in Australia, making them tax neutral.***

4. ***Improve investment and supply certainty by amending section 20 of the Petroleum Resource Rent Tax Assessment Act 1987 (PRRT Act) to link a petroleum project to a production licence where a production licence may revert to a retention lease.***

5. ***Encourage exploration activities by extending the Junior Minerals Exploration Incentive (JMEI) and allowing junior oil and gas explorers to access the scheme.***

An overview of the industry's economic contribution can found at Attachment 1.

ENSURING A POSITIVE AND SUPPORTIVE INVESTMENT ENVIRONMENT

The right fiscal (taxation, commercial and investment) policy settings will help stabilise Australia's oil and gas industry and along with this, the broader economy. The fiscal settings that are needed to underpin the economic recovery required in our economy must ensure Australia can create a positive, competitive, and stable investment and operating environment underpinned by long-term fiscal and regulatory stability.

Creating this environment will help Australia to attract scarce and mobile capital. Ultimately, it is investment capital that will facilitate recovery and growth that will stimulate local economies, create new employment opportunities, and generate long-term government revenue. To assist with Australia's economic recovery, APPEA proposes five immediate actions to attract investment and create jobs:

1. Encourage employment and job creation by ensuring that salary and wage costs are immediately deductible for taxation purposes.
2. Encourage investment and domestic spending through appropriate investment allowances.
3. Remove barriers to business project restructuring through providing tax asset rollover relief.
4. Improve investment and supply certainty by ensuring that taxation laws can keep pace with modern commercial practices.
5. Encourage exploration activities by extending the Junior Minerals Exploration Incentive (JMEI) and allowing junior oil and gas explorers to access the scheme.

These proposals will help set Australia on its path to economic recovery. All this can be achieved without compromising government revenues and the integrity and the underlying principles of Australia's taxation regimes.

Importance of regulatory stability to attracting investment capital

A recent study conducted by Wood Mackenzie[1] noted that Australia's oil and gas industry has been built on stable and predictable regulatory and fiscal settings and considered the conditions required to ensure investment can occur. The report examined the decade prior to the unprecedented wave of investment into oil and gas that occurred during the early 2010s. It established that attractive fiscal settings and regulatory stability between 1999 and 2009 was central to investment of approximately $350 billion occurring.

This investment has already delivered and will continue to deliver direct and indirect benefits in the form of long-term tax payments to governments, increased local employment, supply chain growth through the reliance on local communities to service works, industrial activity to service construction, infrastructure build out, education and upskilling of workers.

However, since 2010 there has been a high degree of fiscal and regulatory instability and intervention. This, in addition to Australia being a relatively high cost[2] destination for doing business, has diminished the attractiveness of Australia as an investment destination. This has impacted investment decisions and reduced the investment appetite of many industries, not just the oil and gas industry.

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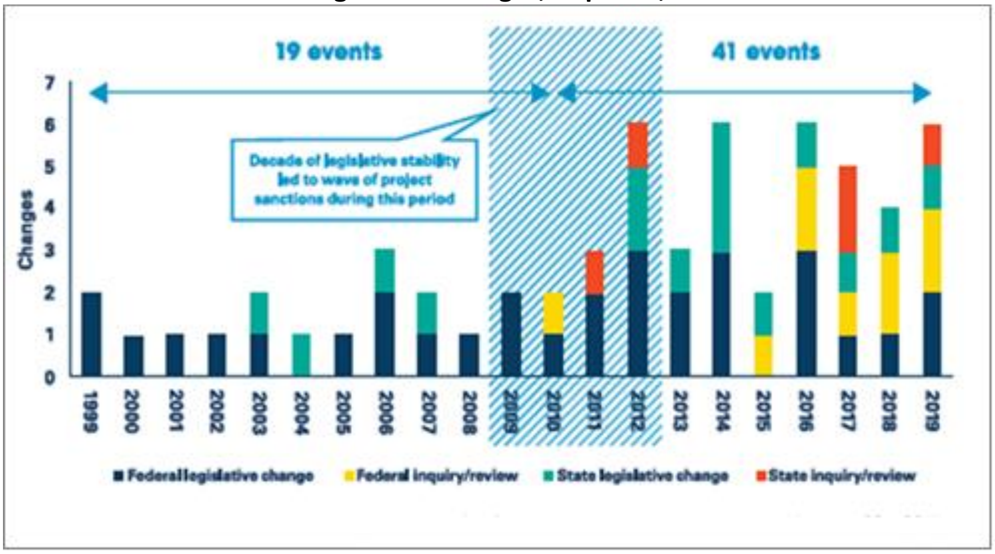
[1] Wood Mackenzie (2020), *Australia Oil & Gas Industry Outlook Report*: appea.com.au/wp-content/uploads/2020/06/Australia-Oil-and-Gas-Industry-Outlook-Report.pdf.

[2] Also adding to this costs is the fact that, compared to many competitor jurisdictions, Australia's oil and gas resources are more geographically remove and often more difficult to develop.

Chart 1. Australian state and federal legislative changes, inquiries, and reviews – 1999 to 2019



Source: Wood Mackenzie (2020)

This loss of attractiveness as a destination for investment is substantiated by the Fraser Institute's *Global Petroleum Survey 2018* released in November 2018. The survey ranked 80 jurisdictions on 'barriers to investment' to oil and gas exploration and production. The survey results indicate that New South Wales (73rd), Victoria (77th) and Tasmania (78th) are amongst the worst 10 jurisdictions in the world. Jurisdictions within this group include Venezuela (80th), Yemen (79th), Libya (76th) and Iraq (75th). These are also the three jurisdictions in Australia that have banned or restricted onshore gas development.

The recent successes of Australia's oil and gas industry should not be taken for granted as other, more accessible, jurisdictions place stress on Australia's competitive advantages. To support economic recovery, Australia will need to position itself as a stable, prospective and lower risk investment destination.

1. Support employment by ensuring that salary and wage costs are immediately deductible

Salary and wages costs represent a significant proportion of costs for capital intensive industries like Australia's oil and gas, infrastructure, mining, utilities distribution and transmission, agriculture, and construction industries. These industries will play a significant role in Australia's economic recovery out of the COVID-19 pandemic.

Legislating the immediate tax deductibility for ***all*** salary and wage costs will significantly simplify company compliance obligations and improve Australia's ability to attract investment capital. It is this investment capital that is needed to provide long lasting benefits to the Australian economy through infrastructure development, job, and employment opportunities and long-term revenue collection to governments.

For many businesses, salary and wages costs are immediately deductible as they are incurred as part of conducting business activities. However, for capital intensive industries, the Australian taxation Office (ATO) often requires that salary and wages costs are capitalised into the cost of an asset. This increases the effective cost of employment.

Making an assessment on the tax deductibility of salary and wages costs to a capital intensive industry or project is not an easy task and the matter is not settled in so far as it applies to infrastructure, construction, and the development of assets, all of which will underpin Australia's economic recovery. This difficulty has been recognised on numerous occasions through the court system, which has previously determined that salary and wage costs should be immediately deductible.

Compliance is dependent on how the facts and circumstances are interpreted by the ATO – there is no bright line test. This highlights the often impractical, time-consuming, and overly complex compliance burden placed on companies to substantiate positions and often, the compliance burden is not predicated on whether the classification made is immaterial or non-existent in the overall economic outcome. As there is no bright line test, the matter is often subject to long-running disputes with the ATO that are costly to resolve, sometimes without any clarity for other taxpayers to follow.

This capitalisation increases the effective cost of employment without any increase in employment itself. The increase of effective cost of these employees filters into the overall project economics, which, in most capital-intensive industries is based off net present value and internal rates of return. Deferring the deduction for a period of 15 years, sometimes over the life of the project (often up to 40 years), decreases the net present value and internal rate of return. These both make Australian projects less competitive as they seek capital for development.

The capitalisation of salary and wage costs inhibits the ability of companies to employ additional workers. It acts as a disincentive to investment, development and ultimately, the creation of jobs in a time of need. In the event project costs need reducing, it may also result in a change of location for certain roles that would otherwise be undertaken in Australia reducing the overall benefit of projects that do get sanctioned to the country.

RECOMMENDATION:

Encourage employment and job creation by making salary and wage costs immediately deductible for all capital intensive industries like infrastructure, mining, utilities distribution and transmission, agriculture, construction and oil and gas.

2. Increasing investment attractiveness through investment allowances

Attracting capital into Australia will be central to our economic recovery from the COVID-19 pandemic. The introduction of an investment allowance will provide an environment that incentivises investment and encourages domestic spending. It can stimulate growth in capital availability, wages, and GDP in the same way as a company tax cut, while also raising national income.

Investment allowances have the benefit of attaching only to new capital spend, thereby removing from the 'fairness equation', a perception that owners of capital previously expended within the country obtain improved project returns for past, as opposed to new, investment decisions.

We believe there are four investment allowances that should be considered independently or as part of a broader investment attractiveness package:

a) Extend and expand the temporary depreciation scheme

The temporary accelerated depreciation scheme that applies until 31 December 2020 to companies with a turnover below $500 million to write off 50 percent of an asset's value in the first year should be extended and expanded.

This can include extending the scheme to capture capital spend until 30 June 2025 and expanding its scope by applying it a broader range of companies. An example of how this expansion in scope could apply is outlined in the table below:

Table 1. Expanding the scope of the temporary depreciation scheme

Turnover threshold	Percentage of capital spend qualifying for write off in first year of spend
$0 – $500 million	100 per cent
>$500 million – $1 billion	70 per cent
>$1 billion – $10 billion	50 per cent
>$10 billion	20 per cent

b) Introduce a broad-based investment allowance

Introduce a broad-based investment allowance applicable to all capital expenditure incurred between budget night and 30 June 2025. This broad-based investment could take two forms:

i. A one-off allowance in the first year that depreciation commences (say 20 per cent) without altering tax depreciation schedules or effective lives, or
ii. Allow a gross up (say 20 per cent) of the asset's value such that a company can depreciate 120 per cent of the asset value over its useful life.

c) Shorten the effective lives of assets

Consideration should be given to shortening the effective life of infrastructure, construction, and development assets by five years (for example, from 15 years to 10 years). Whilst this seeks to adjust the rate that assets decline in value, the shortening of effective asset life means the impact of the "time value of money principle" does not adversely impact companies. This will improve the project net present values and internal rates of return that will help to make the Australian projects more competitive for capital, as well as reducing the economic disincentive to investment, development and ultimately, the creation of jobs.

d) Bring forward the time depreciation commences

For many capital-intensive industries like Australia's oil and gas industry, significant expenditure is incurred in building and constructing assets over a period of time prior to the asset being *"installed and ready for use"*. Furthermore, the time at which assets can be available to be installed and when they are actually installed can also be significant (up to five years in some cases).

To support economic recovery, APPEA recommends an allowance be made for depreciation to commence after two years where the expenditure has been spent and the asset sits in Assets Under Construction (for example, work in progress) because no asset has been installed and ready for use. Alternatively, this could be simplified further by removing the "installed ready for use" principle and replace it with an "asset that is completed and available for installation" principle.

These proposals would help to avoid the delay in depreciation commencement. It means that the value of the asset and depreciation amounts are less impacted by the time value of money, improving net present values and internal rates of return. Whilst this may be viewed as a mere timing difference, in very long construction projects like LNG facilities, it can act as a significant disincentive to investment and development decisions.

RECOMMENDATION:

Introduce investment allowance(s) to provide positive signals and encourage investment, promote domestic spending and increase employment opportunities.

3. Remove barriers to business project restructuring

There is now a need to develop discovered gas resources and ensure the economic life of existing infrastructure is maximised. The objective of any business project must be to maximise the value of the investment made in infrastructure necessary to support the supply of goods / products. There may however be significant challenges in aligning the operational and commercial interests of project participants, including significant taxation impacts. For example, where companies wish to swap their interests in a permit in exchange for an interest in a separate permit or infrastructure, parties are subject to potentially significant tax liabilities despite no immediate economic gain being generated.

APPEA recommends the Government implement reforms to ensure that transactions involving swaps of permits and existing infrastructure in Australia, to the extent value has been merely exchanged, are tax neutral. Any cash component of a transaction (such as where differences in the values of permits or infrastructure exchanged are not the same) should still be subject to tax as per current law.

A "like for like asset" exchange rollover could achieve this outcome, and would be comparable to existing laws in the US and the UK. Rollover relief in these situations should not pose significant revenue concerns as there are no upfront deductions being claimed to reduce other tax profits of the purchaser and there is no forgone tax revenue as the transaction may not have likely otherwise proceeded. The tax liability on the transaction itself is only deferred, not removed. An important point here is that a new revenue stream for Government may be unlocked.

It is also important to note that given Australia's vast size, remote terrain, and distance from markets (both domestic and export), many permit areas which contain discovered resources cannot individually underpin the infrastructure required to undertake high cost exploration and/or development activities. Government should consider facilitating access to multi-user infrastructure to better connect resource to markets. In turn, industry needs to identify options where existing infrastructure can be jointly utilised to reduce costs and open new opportunities.

RECOMMENDATION:

Remove barriers to business project restructuring by reforming the rules around transactions involving swaps of permits and existing infrastructure in Australia, making them tax neutral.

4. Amend the PRRT to reflect current commercial practices

Whilst the principles of the Petroleum Resource Rent Tax (PRRT) remain the right fit for oil and gas operations in Australia, an amendment is required to the *Petroleum Resource Rent Tax Assessment Act 1987* (PRRT Act) to link a petroleum project to a production licence where a production licence may revert to a retention lease. This can be achieved by:

- The specific inclusion of reversion scenarios into the operation of sections 4 and 5 of the PRRT Act, or
- The amendment of section 20 of the PRRT Act to link interests through the project combination.

In commercial practice a petroleum project can go from having a retention lease to a production licence back to a retention lease, yet the legislation does not contemplate this.

This deficiency was acknowledged in the Callaghan Review. It creates fiscal uncertainty and prevents a company's ability to make investment decisions based on economics and value and which reflect commercial practice. The result is that companies are unable to make investment decisions to bring new gas to market due to the fiscal uncertainty that this brings. It is especially problematic for smaller domestic companies who are planning on making significant investments of their scarce capital.

The inability to access deductible expenses has the potential to render additional further investment sub-economic, leading to a premature closing down of a project or stranding assets. The proposed legislative amendment can unlock more investment and supply, particularly to the east coast gas markets. It requires a simple and efficient legislative amendment.

RECOMMENDATION:

Improve investment and supply certainty by amending section 20 of the Petroleum Resource Rent Tax Assessment Act 1987 (PRRT Act) to link a petroleum project to a production licence where a production licence may revert to a retention lease.

5. Encouraging exploration investment and activity in the oil and gas sector

Exploration investment and activity has underpinned the strong contribution made by Australia's oil and gas industry. However, significant economic headwinds faced by the economy challenge the investment environment for junior explorers when the right investment settings are more critical than ever.

The Junior Minerals Exploration Incentive (JMEI) supports the investment environment for junior explorers. It allows junior explorers to attract scarce and mobile capital the international competition for which is greater that it has perhaps ever been. However, expenditure on petroleum (oil and gas) activities is excluded from being converted to exploration credits which diminishes the ability of junior petroleum explorers to attract further investment capital necessary for growth.

The onset of the COVID-19 pandemic has increased the challenges faced by junior explorers. A smaller pool of capital that will be more mobile and subject to tighter hurdle rates will see investment in junior explorers become challenging. Without additional support such as that offered by the JMEI, the impacts on the long-term health of the resources sector, the jobs it creates and the contribution it makes to the economy will be impacted significantly.

APPEA proposes the extension of the JMEI for a further four years and the removal of paragraph 418-80(2)(b) of the *Income Tax Assessment Act 1997*, given the current economic challenges faced by junior explorers. In combination, these recommendations will assist junior explorers engaged in petroleum exploration to attract scarce and mobile capital.

RECOMMENDATION:

Encourage exploration activities by extending the Junior Minerals Exploration Incentive (JMEI) and allowing junior oil and gas explorers to access the scheme.

CONCLUSION

Pursuing a sensible and easy to implement fiscal reform agenda that will support open and competitive markets and help maintain Australia's international competitiveness will see industry and governments work together to enhance the positive role the Australian oil and gas industry can play in contributing to Australia's economic recovery.

There may be a desire to widely increase tax rates and taxation receipts with a short-term view to collecting more revenue in the midst of the current economic crisis. Such a policy disposition must be resisted because it will put at risk the development of long-term, sustainable economic and employment growth opportunities that abound in Australia.

The best option available is for Australia to grow its economy through investment so the debt burden as a percentage of GDP diminishes. The alternative option – aggressive payback a through taxation – will serve only to restrict growth, reduce investment and employment.

It is simply not possible to tax our way back to growth.

The Australian oil and gas industry is ready and committed to support the nation's post COVID-19 economic recovery. A strong economy is vital to helping improve outcomes for all Australians and so we look forward to working collaboratively with governments to help deliver this, without compromising government revenues and the integrity of Australia's taxation regime.

ATTACHMENT 1: THE OIL AND GAS INDUSTRY'S CONTRIBUTION

The Oil and Gas Industry's Contribution

Over the last decade, the oil and gas industry has supported Australia's growth.

TAX

$77bn in taxation receipts

$59bn in export revenue over 2018-2019

Supporting the **growth** of regional Australia & local communities

Supporting **80,000** jobs directly & indirectly

Commited to Australia

When an investment decision is made by the oil and gas industry, a long-term commitment is also made to the Australian economy and community. The profile of oil and gas projects in Australia means that costs incurred are significantly higher than other jurisdictions therefore payback periods are longer.

There may be an urge to increase tax rates across the board to address perceived under receipts. This must be resisted and we must avoid tax reforms that seek to increase tax collections at a cost to the long-term, sustainable development opportunities that abound Australia.

Opportunity for Investment

Australia has an opportunity to secure the next wave of investment which can deliver in excess of $50 billion in capital expenditure.

This would potentially secure up to 5,000 jobs or employment opportunities during construction and 1,300 opportunities during the operation phase, in excess of $800 million annual expenditure, supporting local communities through the purchase of goods and supplies in those areas, and an estimated $80 billion in taxation receipts over the life of the projects. But only if Australia can attract and secure mobile capital.

appea

the voice of australia's oil and gas industry