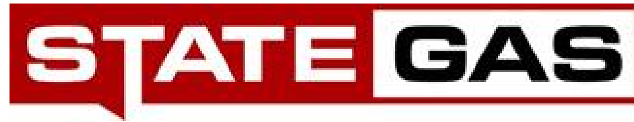

23 July 2020

Committee Secretary
Economics and Governance Committee
Parliament House
George Street
Brisbane QLD 4000

(via email: egc@parliament.qld.gov.au)

Dear Committee Secretary,

Economics and Governance Inquiry into the Royalty Legislation Amendment Bill 2020

Thank you for the opportunity to comment on the Royalty Legislation Amendment Bill. Royalties represent the return to the State for the resource to which they apply and as such are important, but it is also important that they be imposed in a manner which is efficient, provides certainty, and does not present an increased barrier to new development. Fundamental changes to the regime are of very real interest both to industry and the State of Queensland generally.

We note the efforts made by the Royalty Review and, more recently, OSR to consult on the proposed changes. State Gas has participated in these processes, both through its membership of APPEA and in submissions to OSR's process, and commends the adoption of changes in response to industry concerns.

State Gas is a recent entrant into the petroleum industry. Established in 2017, it holds a permit in Central Queensland, which it is actively appraising in order to develop a new supply of gas into the Queensland market. As yet we have no commercial production and are not a current royalty payer however we are vitally interested in the royalty regime in Queensland. As will be appreciated the royalty rate and method for calculation can have material impacts, positive or negative, on the viability of projects and the ability of new projects and market entrants to compete with incumbents.

State Gas appreciates that the current royalty regime pre-dates the emergence of the CSG to LNG industry that now dominates the Queensland petroleum sector, and that particular issues have arisen in the application of royalties to the new industry dynamic. However our concern is that the focus on addressing those issues will result in a new regime that disadvantages and disincentivises entrants to the market, an outcome detrimental to the long term interests of the State.

Our key concern arises from the fact that operating costs no longer have any relevance to the determination of royalty. Currently, operating costs meeting certain criteria are deducted from the gas sale price to determine the wellhead value of gas, from which the royalty liability is calculated. Under the new regime operational costs are irrelevant and royalty is now payable from the first molecule produced (subject to certain statutory exemptions). The impact of this change is to:

- increase the costs of early stage developments;
- raise the threshold for commerciality of projects; and
- reduce the competitiveness of higher cost operations,

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that is, to raise the hurdles to be surmounted by new projects and market entrants and disincentivise growth.

To explain:

- Petroleum projects are capital intensive, with extensive gathering, processing and transportation infrastructure to be constructed and commissioned prior to first commercial sales. The result will be a period of intensive cost, with some small commissioning production prior to the generation of commercial revenues. Under the current system projects effectively benefit from a royalty holiday during this early period, because some limited carry forward of costs is permitted (ie within a royalty year) and royalties are not payable until post wellhead costs reach breakeven.

  The proposed new model changes this, now royalties will be payable prior to the point when revenues are available to pay them and well prior to project break-even. This constitutes an additional burden on the project, an additional hurdle to be surmounted in bringing new gas to the market. The royalty will add to the funds that must be borrowed or otherwise raised to develop the project, so the burden will be not just be the amount of the royalty to be paid, but also the interest or other return that must be paid on the additional funds.

  The new royalty model is one which may be appropriate to existing projects where infrastructure is in place and further production is at marginal cost. However it will operate to disincentivise and raise the hurdles for new gas developments in Queensland.

  The data files issued with the AEMO Gas Statement of Opportunities highlight the additional costs faced by new projects compared to existing. AEMO commissioned CORE Energy to prepare a report on the production costs from various sources (amongst other things). The data file is available at this link: https://aemo.com.au/en/energy-systems/gas/gas-forecasting-and-planning/gas-statement-of-opportunities-gsoo (Core Energy Reserves and Resources and Costs Estimates report, Production Costs tab). It shows the marginal cost of production from existing developed 2P reserves (ie existing projects) in Queensland to be between $2.25 and $3.81. By contrast, the estimated cost of new undeveloped projects (2C) is between $6.45 and $9.44, reflecting the much greater cost of getting a new project off the ground.

- The requirement to pay royalty irrespective of costs increases the threshold at which any given production becomes uneconomic, ie the breakeven point for an operation is increased. This will result in decisions being made to turn off production earlier than would otherwise be the case, for example as an operation reaches the end of its life, or when prices are low (as is currently the case). This will result in less petroleum being produced and less royalty being paid, outcomes that benefit neither the producer nor the State of Queensland.

- As is always the case, the early gas projects in Queensland have exploited the “low hanging fruit”, new projects can be expected to always be either from less productive resources, or in more challenging locations (either for remoteness or other reasons). Accordingly, higher costs must be anticipated, and some of the differences in costs noted in the Core Energy report referred to above reflects this paradigm. A consistent royalty rate irrespective of

operating costs will disadvantage higher cost operations, which must then compete in the market against the existing suppliers with both lower cost operations and lower effective royalty rates. This is not in the interests of encouraging new gas supplies and increasing the diversity of gas supplies coming to market.

We are aware of OSR's preference to avoid introducing complexity into the system as would be necessary to address these issues. However a simple mechanism which would go some way to minimising the disincentives might be to provide a form of royalty relief for new projects, where royalty is not payable prior to and for an initial period (eg 12 months) after first commercial petroleum sale. This would increase the viability of new projects, as well as send a positive message about the State's interest in encouraging new gas and liquids to be brought on-stream.

The changes proposed to the petroleum royalty regime are major changes which will have significant impacts on the industry. Care should be taken to avoid disincentivising activity that brings growth and economic benefit to the State.

Please contact the undersigned should you wish to discuss the above further.

Yours sincerely,

Lucy Snelling
Head, Corporate & Commercial