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 Members,

Economics and Governance Inquiry into the Royalty Legislation Amendment Bill 2020

BACKGROUND

As the preeminent body representing petroleum producers in Queensland and Australia, the Australian Petroleum Production & Exploration Association ("APPEA") welcomes the opportunity to provide a submission to the Economics and Governance Committee ("the Committee") Inquiry into the Royalties Legislation Amendment Bill 2020 ("RLAB 2020").

APPEA are committed to working with the Queensland Government in an open and collaborative manner throughout this process. We want to ensure this new royalty regime is simple, equitable and efficient, does not present an increased barrier to new development, provides certainty for investment and development, and importantly, ensures that Queensland receives an appropriate return for the use of its non-renewable resources.

APPEA SUBMISSION TO THE PREVIOUS IMPLEMENTATION CONSULTATION PROCESS

APPEA notes that we have previously made a submission to Office of State Revenue ("OSR") in relation to the Queensland Petroleum Royalty Review Implementation Consultation Process that outlined a number of suggestions and recommendations. APPEA would like to acknowledge and thank the Queensland Government for considering those recommendations and suggestions, some of which are reflected in RLAB 2020 or otherwise addressed in the Treasurer's introductory reading speech. This includes:

- that sales prices used in determining a royalty liability will not include GST;
- that swap transactions may be the subject of a determination by the commissioner, which we understand from discussions with OSR will recognise swaps as transport arrangements and ignored in price calculations to the extent equal volumes are exchanged in a period; and
- the removal of the mandatory requirement proposed in the consultation paper, to exchange highly confidential and commercially sensitive information with other industry participants for determining royalty liabilities.

A copy of APPEA's submission to the Queensland Petroleum Royalty Review Implementation Consultation Process can be provided at the Committee's request.

ITEMS FOR CONSIDERATION BY THE COMMITTEE

APPEA would like to acknowledge the Queensland Government, the OSR and Industry for the collaborative way this process has been undertaken. We note that considerable work has occurred, and the outcomes achieved thus far have occurred in relatively short time frame – that is, the commencement date of 1 October 2020 will be 11 months after the commencement of Queensland's Petroleum Royalty Review process.

Continuing this positive collaboration process, APPEA would like to make some further recommendations and suggestions. These recommendations and suggestions below are relative to the information that has been made publicly available through the consultation process, RLAB 2020, and the accompanying explanatory notes.

Determination of volume

Presently, there is no public information available as to how volume will be determined and that the OSR have committed to providing guidance on this matter. However, for the benefit of the Committee, APPEA submits that depending on where the petroleum is measured or where the relevant meter is located as part of project infrastructure, there may be differences in measured volumes for the purposes of calculating a royalty liability. For example:

- The types of meters installed at the wellhead are not designed to accurately measure the flow of gas within a small margin for error.
- Some petroleum producers may be able to measure petroleum as it enters pipelines (or gathering pipelines), whilst others may only have a reliable measurement point after the petroleum first leaves a processing facility.
- Volumes measured closer to the wellhead may also include impurities that are not petroleum and so should not be subject to a royalty.

Clear, accurate and verifiable volumes will be central to the application of the Volume Model. The risk with using inaccurate volumes for royalty purposes, is that producers will be faced with the application of a 75 per cent penalty plus interest for any errors in quarterly royalty returns that result in an additional royalty payment.

Therefore, industry needs certainty in the context of this strict regulatory environment. Given the challenges outlined above with the reliability of accurate wellhead measurement of petroleum volumes, APPEA seeks confirmation on the following:

- The criteria that will be applied by the OSR in making a measurement determination. It is submitted by APPEA that in the absence of fraud or evasion, the volumes reported by producers for regulatory purposes are accepted prima facie as the actual volumes reported for royalty calculation purposes, and that these reported amounts will not be subject to review or audit by the OSR as to the accuracy of numbers or the accuracy of wellhead meters.
- The scope of the statement in the Consultation Paper that an adjusted post wellhead measurement is acceptable. In particular, APPEA seeks confirmation this would include volumes calculated at a point of sale with an adjustment (e.g. a gross up number of say 1.5%) to determine the wellhead volume used in determining a royalty liability would be viewed as a reasonable benchmark.

Simplification of the "relevant entity" concept

APPEA understands that the intention of the 'relevant entity' provisions, is to ensure that royalties are paid based on an arm's length price of gas sold. Where there are any non-arm's length sales prices to related parties, those prices are intended to be replaced with either a 'look through to ultimate third party' or a benchmark price.

APPEA submits that the issue with this mechanism in RLAB 2020 is that all transactions with 'relevant entities' are assumed to be non-arm's length. The experience of APPEA's members is that transactions with relevant entities are typically set on an arm's length basis, in accordance with OECD transfer pricing principles.

In our view, the definition of 'relevant entity' is too broad and is likely to capture transactions between parties that are arm's length. APPEA suggests that the definition be amended to restrict its application to circumstances where there is at least majority control by one party over the other.

In addition, APPEA suggests that in the case of sales between a producer and relevant entities that are otherwise at arm's length, the Commissioner should be allowed a discretion (on application by a producer) not to treat the parties as relevant entities for royalty purposes. The Commissioner's discretion could be applied on an entity basis, or in respect of individual sales contracts with particular entities.

Legislating the exclusion of GST

APPEA acknowledges that the Treasurer's introductory reading speech that introduced RLAB 2020 outlined that *"royalty rates for tiers are GST exclusive"*. We understand that the exclusion of GST will apply to all sales prices regardless of commodity or whether benchmarks prices are utilised.

This decision is welcomed as GST is a throughput tax and does not reflect the actual value of the gas and is not captured in the revenues of a business in its reporting systems. The GST component of any sales is ultimately paid directly to the Australian Taxation Office and to include GST in the sales price would effectively be a tax on tax. In addition, given GST does not apply to exports it would distort revenues (and increase royalty amounts) to gas supplied to domestic users.

APPEA notes that RLAB 2020 does not reflect this decision as it was outlined in the Treasurer's introductory reading speech. We recommend that a parliamentary amendment be made to RLAB 2020 to insert a provision for the avoidance of doubt that sales prices and royalty tiers will be GST exclusive.

Use of one benchmark price to whole portfolio

RLAB 2020 provides additional clarity about how benchmark prices will be ascertained and utilised. However, the application of a benchmark price to all project petroleum does not reflect the commercial reality that petroleum can be sold to different consumers and sufficient sales data will exist to appropriately determine a royalty liability.

It is the view of APPEA that the use of benchmark prices should be used as a safeguard fall back for petroleum producers to use in the absence of information, or where the petroleum producer elects to do so for administrative simplicity. Further, the use of benchmark prices for particular volumes of petroleum should not extend to all volumes from that project where the relevant information exists to use actual sales prices in determining a royalty liability.

APPEA recommends that the Committee recommend a parliamentary amendment be made to RLAB to provide petroleum producers the ability to use benchmark prices to the extent the relevant information does not exist and that this does not extend to all petroleum from the project unless the petroleum producer elects to do so.

Rates and tiers for liquid petroleum

APPEA seeks further clarification from the Committee about whether the proposed royalty rate the middle tier for liquid petroleum (see subsection 148K(b)) is correct. The application of an 11.5 per cent royalty rate to liquid petroleum prices between AU$50 and AU$100 per barrel is a significant increase from 3 per cent for liquid petroleum that is AU$50 per barrel or less, and is only 1 per cent lower than the maximum rate of 12.5 per cent that which applies when prices exceed AU$100 per barrel.

By way of contrast, the royalty rate applying to the middle tier for other categories of petroleum, is significantly less than the maximum rate. For example, while the top royalty rate for all types of petroleum is 12.5 per cent, the middle royalty tier for other petroleum classification is as follows:

- 8 per cent for domestic gas;
- 9 per cent for LNG Project Gas; and
- 10 per cent for LNG supply gas.

APPEA suggests that a rate of 9 per cent be applied to the middle tier for liquid petroleum, reflecting an appropriate return to Queensland for the production of its liquid petroleum resources when prices reflect a reasonable economic return, but not at the level where excessive profits are being made.

Lodgement timeframes

The removal of the annual return process places unnecessary compliance burdens on petroleum producers to collect the necessary information on a quarterly basis and lodge quarterly returns within one month of the quarter's end.

This approach disregards the commercial business structures, the time it takes to gather information within an organisation and sign off these returns while completing other reporting requirements due at the same time (e.g. BAS, PAYG, audit reports). Subsequently, any errors that result from late moment changes to contract prices or production volumes resulting in a shortfall may see the imposition of a 75 per cent penalty plus an interest charge.

Under the existing royalty regime, the annual return process provided petroleum producers with a mechanism to adjust annual royalty liabilities that are required due to unforeseen adjustments to production volumes or pricing adjustments.

In the absence of an annual return process, APPEA recommends that:

- lodgement due dates for quarterly returns be extended from one month to two months; and
- quarterly returns can be amended within 12 months from the date of lodgement without penalty where adjustments are the result of purchase price or volume adjustments.

Legislated transitional amnesty period

Given that the Volume Model introduces new issues and complexities not previously contemplated and that a number of uncertainties remain as we approach a 1 October 2020 commencement, APPEA recommends the adoption of a 12-month administrative concession. This concession would ensure that there is no automatic application of the 75 per cent penalty where unforeseen implementation and administrative issues that result in the underpayment of a royalty liability.

Revenue Administration Modernisation Program

The Revenue Administration Modernisation ("RAM") program was undertaken simultaneously with the review of the petroleum royalty regime. APPEA's submissions on the RAM program were in the context of difficulties faced by producers in the existing royalty regime. They were not directed at administrative issues likely to be faced by petroleum producers, under the new royalty regime contemplated in RLAB 2020.

As previously discussed and as is relevant here by way of example, the removal of the annual return as a mechanism for making penalty-free adjustments to quarterly returns lodged throughout the year, is likely to be problematic (but the removal of the Annual Return was not contemplated at the time of the RAM program being undertaken).

ADDITIONAL INFORMATION

APPEA acknowledges that for simplicity in this new royalty regime that the Volume Model does not provide for any deductions or adjustments. This includes a deduction or adjustment to sales prices for transportation costs incurred by a petroleum producer. For the Committee's benefit, APPEA would like to note a concern expressed by some of our members that in certain circumstances the final actual sales prices used will encompass the cost of transporting petroleum to the market.

The cost of this transportation can be a significant part of the cost of doing business and the use of unadjusted price at the point of sale means that Royalty is effectively levied on the incremental transportation cost. In the absence of a change in this regard, market distortions will occur such as sales transactions being closer to the source of production, to minimize payment of royalty on transportation costs or the additional royalty liability burden being passed on to the purchasers of petroleum.

For example, as is the case for domestic gas sales, gas can be sold at multiple locations including ex-plant, at a local trading hub, at a remote trading hub or delivered to a customer. The sales price of the same commodity may vary considerably depending on the location of the point of sale and transportation costs - more recently, transportation costs have exceeded 40% of the final sales price.

Royalty levied on a delivered gas value effectively includes royalty on pipeline infrastructure and operations. This principle is equally applicable to the sale of liquid petroleum which is often trucked long distances to refineries or collection points. For example, the benchmark price for oil/condensate is a Spot Brent price but the only way to achieve an international price like Brent is at an export terminal or a refinery. In Australia these are all located at the coast and oil will need to be transported by pipe or truck to get to that market.

Oil in Queensland is mainly located in the Cooper Basin which is about 1000km from any export market. The average cost to transporting crude oil to those "markets" from Cooper Basin is AU$15 to-AU$25 per barrel – 25 to-35 per cent of the current benchmark price. With royalties being levied on a final sale price which may include an amount that reflects the payment of transportation costs, the new royalty regime may encourage producers to seek a market close to the wellhead. This may shift the market power further towards infrastructure owners and could ultimately impact competition and further investment in Queensland.

With regards to exported LNG, the sales prices will depend on the shipping arrangements of the cargoes and whether cargoes are shipped Free on Board ("FOB") or Delivered Ex-Ship ("DES"). The difference in pricing is because under a DES sale, the customer takes title to the gas at its destination port in another country, which is common with spot cargo sales for LNG. In short, royalties will be payable on the international shipping costs included in the DES sale price

CONCLUDING REMARKS

Circumstances and business models of petroleum producers can vary considerably. Therefore, we note that recommendations and suggestions will apply to petroleum producers to the extent they are relevant.

We look forward to discussing our submission with you. If you have any queries or need further information please contact either myself directly on [redacted] or Georgy Mayo – Director, Queensland on [redacted] or at [redacted].

Kind regards,

Andrew McConville
Chief Executive