Petroleum Resource Rent Tax Gas Transfer Pricing Review

Australians are being short changed by the LNG industry and the way it is taxed. A shift in the way the PRRT estimates transfer prices between a project's upstream extraction and downstream liquefaction to 'netback only' pricing, could increase revenue by $89 billion between 2023 and 2050.

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INTRODUCTION

The Australia Institute welcomes the opportunity to make a submission to the review of transfer pricing arrangements under the Petroleum Resource Rent Tax (PRRT). The concerns raised in our submission to the Callaghan Review remain relevant in 2019 – despite becoming a major liquified natural gas (LNG) exporter, Australians receive little benefit for the large volumes of gas we export. Taxes applied to oil and gas development in Australia are far lower than countries such as Norway, Malaysia or Saudi Arabia. PRRT revenues have been declining.

The Callaghan Review missed opportunities to increase the return to Australians from the sale of hydrocarbon resources. However, its recommendation to review gas transfer pricing methodologies provides a chance to generate considerable revenue - $89 billion between 2023 and 2050, according to the Review's modelling, with a $68 billion increase between 2027 and 2039.[1]

[1] Treasury (2017) *Petroleum Resource Rent Tax Review*, https://treasury.gov.au/consultation/c2019-t364690, p 91

GAS TRANSFER PRICING

The change that would bring this benefit to Australians involves the method by which the price of the gas is derived. In particular, the 'price' of the gas as it is transferred from the extractive process, the getting the gas out of the Earth's crust, over to the process that turns the gas into a liquid that can be put on a ship and sold. This is known as 'transfer pricing'.

For most of Australia's largest gas projects, transfer pricing occurs within the one entity. It is not sold between separate 'upstream' extracting businesses and 'downstream' processing businesses. Because there is no clear sale and no clear price, various methods have been derived to estimate it.

The current default method is known as the residual pricing method (RPM). The RPM actually estimates two prices – the netback price and the cost plus price. The netback price is the price of processed LNG, which is relatively well-known, less the operating and capital costs of the liquefaction process, including a capital 'allowance' of the long term government bond rate (LTBR) plus seven percent. The cost plus price is the operating and capital costs of extracting the gas, plus LTBR +7% capital allowance.

The difference between these two prices per unit of gas is economic rent. Economic rent is any payment that exceeds what is required to compensate the producer, or owner of the resource, for the effort and investment they have put into production. Because companies receiving resource rents have already covered their costs and received the necessary return on capital, the resource rents can be taxed at very high rates without disincentivising investment in the activity. In short, any rent-generating activity that was worth a company's effort before rent taxation, will still be worth the company's time after taxation, no matter what the rate.

From an Australian taxpayers' perspective, we should tax as much as possible of the economic rent generated by the extraction of the nation's gas resources. Yet the RPM considers the 'transfer price' to be half way between the netback price and the cost plus price. This gives away half the rent for free and taxes the remaining half at the internationally-low level of 40%.

The 50:50 split of rent between the upstream and downstream parts of the same business has no economic or logical justification. Instead, PRRT should be levied on a netback only basis, efficiently taxing all of the economic rent. This would effectively assume that the upstream business sells to the downstream business at the price they are willing to pay. This option has been recommended by experts such as Monash University's Dr Diane Kraal and the Tax Justice Network.[2]

CONCLUSION

Australians are being short-changed by the gas industry and the way it is taxed. Many major projects pay no royalties and will not pay PRRT for decades, if ever, due to its many flaws. The increases in greenhouse gas emissions, and broken subsidized promises on carbon capture and storage, rub salt into the wound.[3] A shift to netback only transfer pricing would begin to give Australians some return for the exploitation of the nation's resources.

[2] Kraal (2018) *The government could be boosting the budget bottom line with a change to how it taxes gas*, https://theconversation.com/the-government-could-be-boosting-the-budget-bottom-line-with-a-change-to-how-it-taxes-gas-95782; Tax Justice Network Australia (2019) https://treasury.gov.au/sites/default/files/2019-03/C2017_T211950_Tax-Justice-Network-Australia.pdf

[3] Swann (2018) *Gorgon-tuan Problem*, http://www.tai.org.au/content/gorgon-tuan-problem; Moreton (2018) *Half of Australia's emissions increase linked to WA's Gorgon LNG plant* https://www.theguardian.com/environment/2018/nov/14/half-of-australias-emissions-increase-linked-to-was-gorgon-lng-plant