Recent developments in Australian oil and gas regulation

1. The Carbon Pollution Reduction Scheme

The Australian Federal Government's blueprint for carbon reduction, the Carbon Pollution Reduction Scheme (CPRS), was first articulated in detail in a White Paper – *Australia's Low Pollution Future* – released on 15 December 2008. The White Paper has now largely been reproduced in the Carbon Pollution Reduction Scheme Bill 2009 and associated regulations. The proposed legislative regime will have a significant impact on industry in Australia, including the proponents of LNG facilities as an emissions-intensive industry.

While a guiding principle in drafting governance arrangements for the CPRS has been the need to provide certainty to regulated industries, the scheme’s final design has not been determined. This is largely due to the strong resistance the Bill faces in the Senate where the Government does not hold a clear majority.

Notwithstanding this degree of uncertainty, as the proposed CPRS regime currently stands, a keynote feature of the scheme will be the emissions-intensive trade-exposed assistance program for industry.

Emissions-intensive trade-exposed assistance – free carbon permits

The Australian Federal Government is acutely aware of the risk of 'carbon-leakage' occurring from the introduction of the CPRS. Essentially, carbon-leakage entails existing activities relocating to countries that have not yet adopted schemes to reduce global emissions.

The current proposed solution to carbon-leakage is the emissions-intensive trade-exposed (EITE) assistance program. The proposed scheme will provide free carbon permits ('Australian Emissions Units') for both highly and moderately emissions-intensive activities, until Australia’s major trading competitors adopt comparable carbon constraints.

Applications for free Australian Emissions Units under the EITE program must be submitted by 31 October of each financial year for which assistance is being sought.

It appears from the draft regulations relating to the operation of the EITE assistance program that moderately emissions-intensive industries (such as the LNG production industry) will receive an assistance rate of 66% in the 2011-12 financial year, which will diminish incrementally to 53.5% by the 2020-21 financial year (when the 'global recession buffer' ceases to apply).

This is a topic which requires regular monitoring as the political and global contexts evolve.

2. Carbon capture and storage

To complement the CPRS, the Australian Federal Government has looked to carbon dioxide capture and geological storage (CCS) technology as a viable carbon emissions mitigation model. The commercialisation of this technology will be critical to the Government meeting its target reduction in emissions.

By injecting carbon dioxide into deep underground formations such as depleted oil and gas fields, CCS may provide for the long-term storage of carbon emissions. The Federal
Government recently amended the *Commonwealth Offshore Petroleum Act 2006* (now the *Offshore Petroleum and Greenhouse Gas Storage Act 2006* (the *OPGGS Act*)) to provide for a CCS regulatory regime, which will be supported by regulations and guidelines.

The legislative structure provides for access and tenure rights for ocean sequestration in Australian Commonwealth waters, in addition to all the attendant issues of a CCS regime including health, safety and environmental requirements. The OPGGS Act employs a licensing framework broadly similar to that used for petroleum activities, including greenhouse gas assessment permits, holding leases and injection licences as well as ancillary titles.

Implementing the CCS scheme to co-exist with the petroleum regime in the OPGGS Act reflects the similarities in the technologies, equipment, techniques and geological formations that are used in both CCS and petroleum extraction. Accordingly, a critical feature of the legislation is the balancing of potentially incongruent interests of petroleum titleholders and CCS titleholders, with priority afforded to pre-existing petroleum titles.

Australia's states and territories have enacted, or are seeking to enact, comparable legislative provisions for their respective jurisdictional waters.

3. **Petroleum resource rent tax amendments**

Petroleum Resource Rent Tax (*PRRT*) is Australia's principal offshore petroleum taxation mechanism which, under the *Petroleum Resource Rent Tax Assessment Act 1987* (the *PRRT Act*), levies a tax on profits derived from petroleum projects conducted in most Commonwealth offshore areas under the OPGGS Act. The PRRT is levied on the taxable profits of a petroleum project at the rate of 40%, with taxable profits assessed on the excess of the project's assessable receipts less the project's deductible expenditure.

In June 2009, the Australian Federal Government enacted a series of amendments to the PRRT regime. These reforms include implementing:

- the functional currency rule;
- a 'look back' rule for exploration expenditure; and
- an extension of the frontier exploration tax concession.

**Functional currency rule**

The functional currency translation rules are an exception to the general translation rules, that require foreign currency amounts to be translated into Australian dollars for tax purposes. Changes to the PRRT Act will allow liable petroleum producers, whose accounts are kept solely or predominately in a particular foreign currency, to elect to calculate their PRRT liability in the currency in which their petroleum project accounts are maintained (for example, US dollars).

It is expected that the amendment will reduce compliance costs for PRRT taxpayers and simplify reporting for foreign entities with interests in Australian petroleum projects.

**'Look back' rule**

This amendment to the PRRT regime will ensure that all exploration expenditure related to a production licence derived from a relevant exploration permit or retention lease is
deductible for PRRT purposes. The new provisions remedy the previous circumstance where certain exploration expenditure incurred in the exploration permit or retention lease area (prior to the grant of the retention lease or production licence) was not regarded as being associated with the ultimate production licence area, and was therefore non-deductible for PRRT purposes.

Extension of frontier exploration tax concession

In light of Australia's declining liquid fuel self-sufficiency and the growing need to unlock new petroleum laden provinces, the Federal Government has extended the frontier exploration tax concession, first announced in 2004, to include the 2009 annual offshore acreage release to stimulate exploration of especially high-risk acreages.

The fiscal initiative applies to exploration activities in prescribed locations, nominated by the Federal Minister for Resources and Energy, under the PRRT Act. The targeted locations, which may constitute up to 20% of exploration permit areas released in a year, are known as 'designated frontier areas' and are characteristically remote and deepwater. The acreage must be more than 100 km from an existing commercialised petroleum discovery, and must not be adjacent to an area designated in the Federal Government's previous year's acreage release.

The policy rationale underwriting the frontier tax concession is the need to recognise and respond to the considerable expenditure and risks companies absorb in exploring Australia's remote offshore areas. The concession allows a 150% uplift on PRRT deductible expenditure for exploration incurred in designated frontier acreages.

4. Retention lease policy review

A retention lease may be obtained following a discovery of petroleum in an exploration permit, the recovery of which is not currently commercially viable, but is likely to become commercially viable within 15 years. To this end, the Federal Government applies a 'commerciality test' which, in broad terms, assesses whether the petroleum could be developed:

- given existing knowledge of the field;
- having regard to prevailing market conditions; and
- using proven technology readily available within the industry,

such that the commercial rates of return from the recovery of petroleum meet or exceed the minimum return considered acceptable by a 'reasonable petroleum developer' or industry investor for the nature of the project at hand.

Notwithstanding the conventional benefits of the retention lease policy to the oil and gas industry, in the current commercial landscape of offshore development, the Federal Government is becoming increasingly troubled by the proliferation of retention leases, which some consider is unduly decelerating the orderly evolution from exploration to production. For example, the Government believes oil and gas companies may delay developing Australian resources in favour of overseas projects, owing principally to Australia's lack of sovereign risk. The perceived 'warehousing of resources' effect led the Minister for Resources and Energy to warn, on 12 June 2009, that the Joint Authority (the
entity with carriage of administering offshore petroleum activities) will more ‘rigorously’
apply the commerciality test to applications for retention leases and their renewal in order
to ensure that oil/gas fields are developed at the earliest possible time.

Accordingly, the new policy will introduce a 'use-it-or-lose-it' approach to oil and gas
companies considered to be hoarding significant petroleum reserves through retention
leases.

5. **WA domestic gas reservation policy**

In October 2006, the former Western Australian Government released the *WA Government
Policy on Securing Domestic Gas Supplies* (the *Domgas policy*), which has since received
in-principle endorsement from the current State Government. The policy was designed to
guarantee the sufficient long-term supply of gas to the Western Australian market.
However, given that most gas found offshore Western Australia falls within Commonwealth
jurisdictional waters, application of the Domgas policy, from a constitutional perspective,
may prove problematic for the Western Australian Government.

The thrust of the Domgas policy requires that the equivalent of 15% of gas production from
new export LNG projects should be reserved for domestic consumption. The Domgas
policy is not enshrined in legislation and is therefore not embedded with the force of law.
However, the Western Australian Government does have a number of levers to enforce its
policy, and is likely to impose the obligation as a condition to LNG projects gaining access
to Western Australian lands and territorial seas.

As part of its overall strategy to increase Western Australia's gas supply, the Western
Australian Government also recently announced that it would reduce the royalty rate on the
value of gas produced from all 'tight gas' fields from 10% to 5% of well-head value. The
term 'tight gas' refers to gas extracted from onshore rock reservoirs (and from known
offshore reserves) which is more capital intensive to extract than gas produced from
conventional sources, and which is therefore more expensive to produce.

6. **Coal seam gas and overlapping title legislation (Queensland)**

As traditional sources of gas reserves decline, and new fields become increasingly difficult
to discover, coal seam gas (*CSG*), predominantly found throughout eastern Australia, has
emerged as an exciting new opportunity for significant production. CSG is created at the
time coal was formed and is trapped in, and produced from, the coal seams or 'cleats'
within coal. Given the rapid development of the CSG industry in recent years, particularly in
Queensland, the Queensland Government has implemented a legislative framework to
regulate access rights for CSG proponents over land which is the subject of pre-existing
mining tenements, such as coal mining leases.

The Queensland legislative regime provides that the proponent who is 'first in time' with a
production tenure application gains a certain level of precedence to the chosen resource,
while at the same time encouraging the co-development of both CSG and coal to optimise
the recovery of both resources. The right to produce CSG commercially is only by way of a
petroleum lease and a petroleum lease will only be granted over an existing coal mining
lease (and vice versa) if the mining lease holder consents to a 'coordination arrangement'
with the petroleum lease applicant. While there is an obligation on the parties to 'make reasonable attempts' to reach such a coordination arrangement, the parties cannot be compelled to do so. If such agreement cannot be reached with the mining lease holder regarding the coordination of the timing and impact of extraction of CSG and the mining of coal, then the petroleum lease will not to be granted.

An issue that has also arisen from the development of the CSG industry is the disposal of CSG water that is extracted from coal seams during the CSG production process. In May 2009, the Queensland Government released its draft discussion paper on the Management of Water produced from Coal Seam Gas Production. The discussion paper sets out the Queensland Government's current policy relating to the management of CSG water which includes ensuring that CSG producers are responsible for its treatment and disposal, discontinuing the use of evaporation ponds as a primary means of disposal, remediating existing evaporation ponds, and ensuring that water in excess of what can be beneficially used (or injected into natural underground reservoirs of equal or lesser water quality) is aggregated for disposal. The discussion paper also seeks views on the Government's position that the CSG industry be required to develop and fund a CSG water aggregation and disposal system to deal with CSG water which cannot be directly injected back underground or has no immediate customers. The closing date for submissions on the CSG discussion paper was 1 June 2009. The Queensland Government will assess the submissions before issuing its final policy.

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