



Woodside Submission

Review of the PRRT Gas Transfer Pricing arrangements

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1. Executive Summary

The Gas Transfer Pricing regulations (regulations) were originally developed by Government over several years in consultation with industry and with input from independent experts.

These regulations (in particular the Residual Pricing Method, or RPM) have provided certainty for the industry under the Petroleum Resource Rent Tax (PRRT) regime. Such certainty helped underpin the confidence for record investment in Australian Liquefied Natural Gas (LNG) projects, including the Woodside operated Pluto LNG project and our investment in the Wheatstone LNG project.

The possibility of changes to PRRT settings emerging from the review has disturbed the decision-making environment for the Australian LNG industry. However, Woodside supports the review objective of ensuring the regulations (including RPM) continue to be fit for purpose for the future investments in Australian LNG. As typified by Woodside's Burrup Hub vision, this next wave may largely involve maximising the use of existing infrastructure rather than construction of new greenfield LNG projects.

In Woodside's view, the review should be undertaken with three key principles in mind:

1. Certainty of application for the taxpayer

The regulations need to continue to provide the certainty and confidence for this next wave of investment. The case for change needs to be made and supported by considered analysis – including the views of independent experts where appropriate. The conclusions reached in the original development of the regulations should not be summarily dismissed. The introduction of subjective elements or uncertainty into the methodology should be avoided.

2. Respect for existing investments

If any changes are recommended by the review, it will be important that these are proposed with only prospective effect. Existing investments, including projects which are sanctioned prior to the completion of the review based on the current regulations should be respected and not made subject to retrospective changes.

3. Continued accommodation for multiple use of infrastructure

The current regulations already recognise the potential for the use of existing infrastructure to process LNG from more than one PRRT project and include the necessary adjustment mechanisms. This potential for the 'multiple use' of infrastructure is embedded within the regulations and means the regulations remain fit for purpose for many future developments, including for PRRT projects which may obtain LNG processing services under toll arrangements with existing infrastructure owners.

2. Woodside's Future Investments

2.1 The Burrup Hub

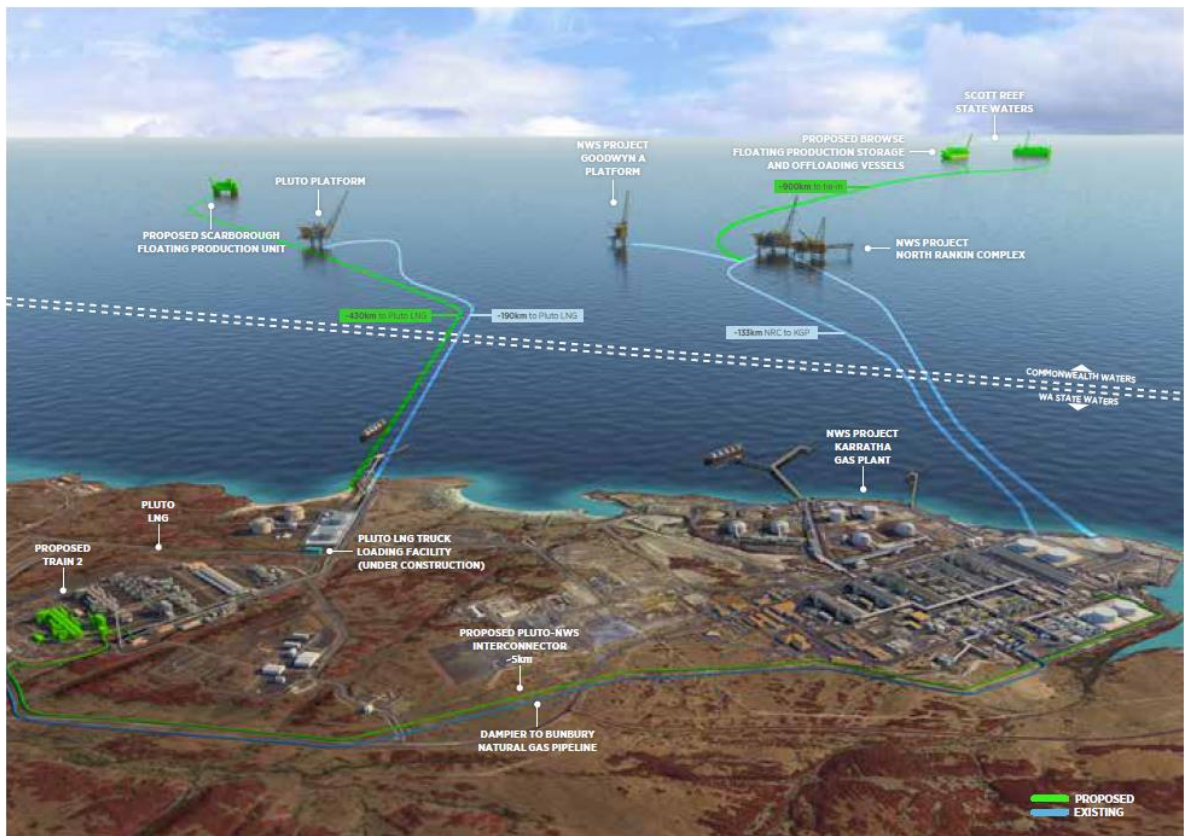
Woodside is aiming to create a regional LNG production hub on the Burrup Peninsula, where we have been safely and reliably operating for more than 30 years. Our vision for the Burrup Hub involves the proposed development of some 20 to 25 trillion cubic feet (Tcf) of gross dry gas resources from Scarborough, Browse and Pluto, relying on our existing and proven LNG facilities – Pluto LNG and the Karratha Gas Plant (KGP).

The Burrup Hub would supply domestic and export markets for decades to come and ensure Australia is a key supplier to meet the emerging LNG supply gap. The hub is also intended to provide the infrastructure to process other third-party resources in the future. It has the potential to unlock and process more gas than the entire volume which has been extracted from the North West Shelf (NWS) since start-up in 1984.

The final investment decisions (FIDs) for the projects that will give rise to the Burrup Hub are approaching. Subject to positive FIDs, from 2020 in excess of A\$40 billion would start to be required from Woodside and our joint venture participants. Woodside calculates that the Burrup Hub growth projects we are considering can support up to 5,000 direct jobs in the construction phase and sustain an average of 2,000 direct jobs in steady state operations, plus thousands more throughout the supply chain.

In this context and given the length of time spent in the original development of the regulations, Woodside respectfully contends that a case for change first needs to be made. Such changes, if supported by considered analysis, should then be proposed only with prospective effect – that is to projects which successfully apply for a production licence after the conclusion of the review. In addition, any changes should not taint projects sanctioned prior to the effective date of the changes by subjecting them to new provisions if these projects are combined with production licences issued after the effective date for the changes.

An overview of the key components of the Burrup Hub is depicted in the diagram below and further information on the related projects follows.



Conceptual only, not to scale. Developments are subject to joint venture approvals, regulatory approvals and relevant commercial arrangements.

2.1.1 Scarborough to Pluto

The Scarborough gas resource is located approximately 375km off the Burrup Peninsula. Woodside is proposing to develop the 7.3 Tcf Scarborough gas field through new offshore facilities connected to a brownfield expansion of the existing Pluto LNG onshore facilities, including construction of a second LNG train. The offshore development initially includes up to seven subsea, high-rate gas wells feeding to a semi-submersible floating production unit. An approximate 430 km pipeline will transport the dry gas to shore.

Expansion of the Pluto onshore facilities provides the potential to accelerate other offshore Pluto gas reserves and enables future development of third-party resources.

Woodside has commenced front end engineering and design (FEED) for the offshore and onshore stages of the Scarborough to Pluto development and is targeting a FID in 2020.

2.1.2 Browse to NWS development

Located approximately 425 km North of Broome in the offshore Browse Basin, the Browse fields (Calliance, Brecknock and Torosa) contain predominantly gas, with contingent resources of 13.9 Tcf of dry gas and approximately 390 million barrels of condensate.

The Browse to NWS development concept is based on two floating production storage and offloading (FPSO) facilities connected to an approximate 900 km pipeline to existing NWS infrastructure. This would involve production from the Browse fields through the NWS infrastructure of around 10 million tons per annum (Mtpa) of LNG/Liquid Petroleum Gas and 1.4 Mtpa of domestic gas (100% project). Measured with reference to LNG, production from Browse will be double that of Pluto LNG.

Woodside is targeting a late 2020 FID for the Browse to NWS development (subject to joint venture approvals) and commencement of production from Calliance and Brecknock in 2026 and 2027 for Torosa.

Long term processing of third-party gas, such as Browse, at KGP will transition the KGP into a third-party tolling facility and extend the life of the facility for decades.

2.1.3 Pluto to NWS interconnector

Woodside is proposing a pipeline to transport gas from Pluto LNG to KGP. This interconnector is intended to provide further flexibility to fill short-term spare capacity at the KGP, including potential acceleration of processing of Pluto area reserves at the KGP as well as other third-party gas. Woodside is proposing the pipeline between the two facilities would be owned and operated by a third party.

*

Woodside's comments on the important technical features in the regulations follow in the subsequent sections of this submission.

3. Emerging Developments and Tolling Arrangements

One of the stated objectives from the Treasury Consultation Paper is:

“ensuring the regulations are fit for purpose into the future and compatible with emerging developments in the industry, such as liquefied natural gas (LNG) tolling arrangements and third party processing.”

This objective is critically important given that future developments in the Australian LNG industry, including the proposed Woodside operated Browse and Scarborough projects, will predominantly involve processing gas from offshore fields through existing or expanded onshore infrastructure. In many cases, these developments are expected to involve commercial tolling arrangements with existing infrastructure owners.

Clarity in the application of the regulations to developments of this nature is necessary to help provide the certainty and confidence necessary as FID’s approach for these large-scale investments.

In Woodside’s view and consistent with the technical position outlined in the APPEA submission, the current regulations already recognise and accommodate the use of existing infrastructure to process LNG from more than one PRRT project. This concept of ‘multiple use’ is inherent in the Residual Profit Method (RPM) calculation methodology and specifically referred to in the design of the RPM, as evidenced by comments and examples in the 2005 Explanatory Statement.

Woodside fully supports the technical analysis outlined in APPEA’s submission with regard to the application of the RPM from the perspective of both an existing infrastructure owner project (‘Host Project’) and from the perspective of a resource owner project that obtains LNG processing services from the infrastructure owner (‘Shipper Project’). In this regard, Woodside considers that the existing regulations provide appropriate technical and practical outcomes for projects involving tolling arrangements.

As noted by APPEA, we would welcome clarification of this as a policy position to provide certainty for tolling projects going forward.

4. Specific Features of the RPM

4.1 Division of residual profit element

Woodside notes the following comments in the Treasury Consultation Paper with regard to the division of the residual profit element in the RPM:

The 50:50 profit split is an arbitrary allocation and is not based on any economic or theoretical reason. It reflected that when the regulations were developed, there was little prior experience to draw from, and an equal split seemed a good starting point for allocating the profits.

The RPM is effectively a mechanical implementation of the Profit Split Method endorsed by the Organisation for Economic Co-operation and Development (OECD). As commented by the OECD, the Profit Split Method is an appropriate method to approximate the arm's length results that would have been achieved between independent enterprises where the following circumstances exist:

1. Each party (i.e. notional upstream and downstream party) makes unique and valuable contributions
2. The business operations are highly integrated such that the contributions of the parties cannot be reliably evaluated in isolation from each other
3. The parties share the assumption of economically significant risks, or separately assume closely related risks
4. There is a lack of reliable comparable transactions.

The 50:50 residual profit split in the RPM reflects the integrated and interdependent nature of an integrated Gas-To-Liquid (GTL) operation and the principle of sharing residual profits generated by the operation equally across all cost centres. Consistent with this principle, there is also symmetry in the calculation for the notional upstream and downstream parties with regard to the treatment and recovery of the costs of the operation. Respectfully, it is not appropriate to dismiss the contribution of the notional downstream entity or other parts of the value chain to the operation. Value is created at every stage of the LNG process. As discussed in the 1998 Arthur Andersen report released by the Treasury:

“gas is worth little without a mechanism to get it to a market (ie through liquefaction) and the processing is worth little without access to a large and sustainable supply of cost effective gas”

Any proposal to change the 50:50 residual profit split should be supported by considered analysis and should not dismiss the original intent of the RPM calculation. It is on this feature of the RPM that the findings of independent experts could be informative. The introduction of subjective elements into the determination of the residual profit split should also be avoided due to the significant uncertainty and complexity, together with compliance and substantiation issues this would introduce

4.2 Capital allowance rate

Woodside considers that the uniform capital allowance rate [7% + Long Term Bond Rate (LTBR)] applied to both upstream and downstream capital costs in the RPM is not unreasonable. All Australian LNG projects to date have been developed by integrated exploration and production companies and would typically apply a single hurdle rate to investment decisions.

We also note the National Offshore Petroleum Titles Administrator (NOPTA) published hurdle rate for consideration of the commerciality of retention lease applications of 12%.

4.3 Other RPM features

Woodside supports the comments expressed in the APPEA submission in regard to the following elements of the RPM that are canvassed in the Treasury Consultation Paper:

1. Exclusion of exploration and abandonment/decommissioning costs

We note that the starting point for the upstream stage as defined in the regulations is relevantly the “the recovery of project natural gas...”. This fits with the principle that a notional upstream entity would not seek to recover its sunk exploration costs when negotiating an arm’s length sales price with a notional downstream entity. Nor would a notional downstream entity be prepared to pay for those costs.

2. Cost Plus / Netback interaction

This includes the RPM default to the netback price in years where this netback is lower than the cost-plus price for the operation.

5. Comparable Uncontrolled Prices

5.1 Comparable uncontrolled prices and shadow prices

The identification of comparable uncontrolled prices (CUP) to inform the gas transfer price as being unlikely in practice is acknowledged in the Treasury Consultation Paper. In Woodside's view, it is also extremely unlikely that any CUP, even if temporarily identified, would continue to meet the comparability conditions over any significant period of time to provide a long-term gas transfer reference price for an LNG project. In contrast, the RPM thus provides a reliable and predictable self-assessment mechanism.

Woodside further supports the views expressed in the APPEA submission (and supported by input from Deloitte) that performing adjustments to enhance comparability of an uncontrolled price is challenging and of questionable reliability and sustainability on a long-term basis. The expanded use of such adjustments risks introducing subjective factors which may call into question the relevancy of the potential CUP as a starting point.

5.2 Use of tolling transactions to inform the Gas Transfer Price

Whether "an observable arm's length price for tolling arrangements is useful in testing the commerciality of outcomes under the RPM" is also considered in the Treasury Consultation Paper. More specifically, it is queried whether subtracting an arm's length tolling price (if paid for by the seller) from the LNG sales price would provide an indication whether the RPM calculation for the same project was delivering too high a return to the downstream.

Woodside supports the technical views expressed in the APPEA submission in response to these questions. In addition, Woodside considers it is important to acknowledge the context of integrated GTL operations. In most circumstances where a project (Shipper Project) is obtaining tolling services from a third party (Host Project), the Shipper Project should be regarded as having an integrated GTL operation separate from that of the Host Project.

Consequently, the tolling price paid by the Shipper Project should be regarded as an operating cost of the Shipper Project's integrated GTL operation. This means that the toll should be included in the RPM calculation for the Shipper Project through the normal operation of the rules (including apportionment of upstream and downstream components of the toll where applicable).

However, from the Host Project's perspective, the toll price achieved should not be relevant to the calculation of the Host Project RPM price. By its nature, an arm's length toll price reflects the outcome of a commercial agreement for tolling *services* between Host Project and Shipper Project. In essence, the toll price the Host Project is willing to accept is determined with reference to its infrastructure, and not with any reference to the underlying hydrocarbons the PRRT/RPM is designed to tax.

Turning then to the question of if an observable arm's length toll price is useful in testing the commerciality of RPM outcomes; as noted in the Treasury Consultation Paper, toll prices are subject to material differences and variability depending on the functions performed, assets used, and risks shared between the Host Project and Shipper Project.

Further, the returns sought by a Host Project from a tolling arrangement may be influenced by extraneous or variable factors such as the stage of the Host Project life cycle, the term of the tolling arrangement, whether the Host Project has risked capital expenditure or has already recovered its investment cost.

Accordingly, Woodside considers the determination of a toll price between two projects is a separate matter to determining a gas transfer price (i.e. an arm's length price for the *purchase* of sales gas) between the notional upstream and downstream parts *within* the Host Project or *within* the Shipper Project. The RPM is designed to calculate the gas transfer price in these circumstances. A toll price should, therefore, not be used as a proxy or starting point to infer a gas transfer price.

Woodside does not consider that scientific adjustments could be made to an observable toll price to more reliably arrive at a gas transfer price. Any such adjustments would likely be subjective in nature and introduce significant elements of uncertainty into the calculation of the gas transfer price. The adjustments would also likely be difficult to support in practice given factors such as non-alignment of taxing points and tolling points and the significant variability in the terms of different tolling arrangements.

In many respects, the strengths of the RPM over and above other methods were summarised in the Callaghan Report:

“The strength of the RPM is that it is a single method that is designed to apply to all LNG projects. The RPM removes the uncertainty that usually arises in valuation matters whether by arm’s length or market valuation principles. Changing the valuation method for sales gas away from the RPM to a different method, either using arm’s length or market valuation principles, may present greater challenges in terms of transparency, equality, auditability and simplicity.”

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