CHALLENGES FOR THE INDEPENDENT AUSTRALIAN PETROLEUM EXPLORATION COMPANIES

by

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For the purposes of this discussion small Australian explorers are defined as those companies without a cash flow who are exploring with capital raised by way of a Prospectus from the equity market.

These companies are faced with three problems:

1. how to acquire acreage suitable for a small explorer;
2. how to acquire a technically competent operating staff; and
3. how to raise finance.

Every company has its own philosophy on acreage acquisition but perhaps the most conservative approach would be threefold:

firstly, to acquire acreage onshore and to apply for offshore acreage only in exceptional circumstances;

secondly, to acquire acreage only in basins with known hydrocarbon accumulations; and

thirdly, to maintain the level of direct interests in permits at between 10 to 30 per cent.

By adhering to these policies, such a company would reduce its exploration risk and maximise its exposure to wildcap drilling within its allowable budget.

The second problem these companies face is obtaining technically competent staff. This is extremely difficult in view of the severe shortage of such people in Australia. Attraction of staff with international expertise from overseas is difficult because of Australia's onerus personal taxation regime. Experience has shown that suitable Australian personnel stationed overseas have returned to Australia because they had a personal desire to do so, and not because of the salaries offered. One unexpected windfall in this respect has come from the Socialist policies of the Trudeau Government in Canada. The immediate collapse of oil exploration in Canada has given Australian exploration companies many excellent Canadian technical personnel, which will add to the overall wealth of the nation.

Another method companies can use to attract technical personnel is to offer stock options. The creation of the employee stock option schemes is very difficult in public issues because Underwriters and Financial Institutions believe the rights of the shareholders are being prejudiced. While it is true that granting royalties to staff does put them in a preferred status to the shareholders, the granting of stock options give the staff the opportunity to participate equally with the shareholders in the success of the company. One group puts up money, the other group finds the oil and gas. Surely employee stock options, provided they do not represent an excessive percentage of the company, are a fair and equitable method of rewarding the technical staff without prejudicing the rights of the shareholders, especially where Australia's financial and taxation structure makes it difficult, as stated, to provide a salary incentive, net of taxation, comparable to that available internationally.

One problem with stock options is Section 26 AAC of the Income Tax Assessment Act 1936 as amended. This section assesses *as income* the difference between the exercise price of the shares and the market price of the shares when exercised, *even though* the shares have *not* been sold and *no* profit has actually been made. This is undoubtedly the most inequitable section of an already inequitable Act.

With respect to actual salaries paid to technical staff, the recent explosion in petroleum exploration, not only in Australia but worldwide, has put upward pressure on these salaries. It has become very difficult, not only for small explorers but also for larger and overseas companies to keep pace. Small Australian

explorers have also put additional pressure on these salaries since a premium has to be paid to work for a company that may not exist in two years time.

The third problem the companies face is raising finance. In good times, these companies can raise capital by way of public issues supported by a Prospectus. This is, however, a most tedious and frustrating method of financing oil exploration. For a start, each Prospectus can take 8 to 12 months to prepare from inception to registration. During this time, companies can still be acquiring acreage thus causing continual alterations to the Prospectus. Between registration of a Prospectus and listing on the Stock Exchanges a company is *not* allowed under the Companies Act and Corporate Affairs to carry on business. Hence, during this time, the Chief Executive is in constant danger of being in breach of the law. A Prospectus is also hampered by thousands of minute regulations. For example, a professional resume can not be included in a Prospectus without the written approval of all the companies that person had worked for. These are just some of the many problems.

Many companies, in issuing their Prospectus, take advantage of Section 160 ACA of the Income Tax Assessment Act. This section allows an investor a 30 per cent rebate on subscriptions to petroleum exploration companies. At first glance this appears to be an excellent incentive for petroleum exploration. However, the entire capital raised by public subscription of companies which offer the rebate, is *not* allowable to the company as a tax deduction on future income. Therefore, although such companies may have been aggressive explorers in Australia, they may actually incur a taxable income due to the current high interest rates. Of the investors who subscribed to the rebate, at least 80 per cent would have sold out within the twelve months and therefore would *not* be eligible for the rebate. Now it would be expected that the Taxation Department would consider this to be an extremely beneficial section of the Act. However, they are actively deferring and disallowing the rebate for those loyal shareholders who have ridden the rollercoaster ride of share prices during the 1980-81 Financial Year. They have also reduced the rebate to 27 per cent. Those investors who look to Section 160 ACA as a method of both minimising their taxable income and participating in Australia's oil exploration would be forgiven for switching their funds into Macadamia Nuts.

Having raised their initial funds, companies still have active ongoing exploration programmes. There will come a time when future funds are required. This can be currently done by two methods:

1. by a rights issue; or
2. by private placement.

Both these methods can only be efficiently implemented during strong stock market conditions. The Australian stock market, being small by international standards, is totally dominated by overseas trends which may bear no reality to the requirements of the Australian petroleum exploration industry at that time. This is the situation today, booming petroleum exploration successes and the need for urgent Australian funds but a bear market and no method of raising these funds. Because of this situation, companies have farmed out a number of their obligations and have therefore deferred their requirements for additional funds until the market improves. Because all Australian companies are in a similar situation, these farmouts were therefore to overseas companies with independent cash flow. This unfortunately is circumventing the role of the small explorer.

The Federal Government has set down clear guidelines to ensure 50 per cent or more Australian participation in resource development and production in Australia. These guidelines are being rigidly enforced by the Foreign Investment Review Board. Overseas companies exploring for petroleum in Australia and knowing they must have 50 per cent Australian participation for development, are therefore actively seeking 50 per cent Australian participation at the exploration stage.

During 1981, there were approximately 104 onshore and 15 offshore exploration wells drilled or drilling in Australia. In this context exploration wells are defined as wildcat wells and exclude appraisal wells on existing discoveries. As expected of the 15 offshore wells only about 25 to 30 per cent of the cost of these wells was made by Australian companies. However, of the 104 onshore wells, 85 per cent of the cost of these was made by Australian companies and this figure only reduces to 80 per cent if the Cooper Basin exploration expenditure is excluded. These figures can be broken down further to give a 35 per cent contribution to onshore exploration wells by small Australian exploration companies. Small Australian explorers, as operators, completed 27 exploration wells during 1981 of which 5 encountered commercial flows of hydrocarbons. That is a success ratio of about 1 in 5 which is certainly comparable to the Australian average. Therefore, it can be demonstrated that the small Australian explorer makes a significant financial

and technical contribution to Australia's onshore exploration programme and greatly assists in the attainment of the Government's 50 per cent participation guidelines.

But what of the future? As indicated earlier, companies are being forced by the market conditions to farmout some of their interests to overseas companies, with the result that Australia's participation in oil exploration in Australia is declining. The small Australian explorer therefore has to look at improved or alternate methods of finance.

What options are there for alternate financing of exploration? Firstly, the present Section 160 ACA provisions of the Income Tax Assessment Act, which are of little value in their present form, could be modified to truly provide taxation incentive to the Australian investor without penalising the company. The rebate should be 46 per cent (not 27 per cent) and this would provide shareholders with the same tax relief available to companies who participate directly in oil exploration. And all exploration expenditure from these funds should be deductible from future income by that company.

Alternately, Section 160 ACA could be replaced by the Drilling Fund concept whereby individuals could participate directly in petroleum exploration rather than holding share certificates. There has been a great deal of discussion concerning the viability of Limited Partnerships in the Australian legal and taxation environments. However, if legislation covering Limited Partnerships in Queensland and Western Australia could be changed to accommodate 1,000 partners instead of 20, this would greatly accelerate the introduction of Drilling Funds as a method of financing petroleum exploration.

Of course, all these methods will be to no avail if the current recommendations of the Senate Inquiry into a Resource Rent Tax are implemented by the Government. This indeed is the greatest threat to the small Australian explorer, even more so than the recent bear stock market. Shareholders of small Australian explorers take an enormous risk on their investments, and the term investment is used loosely, and they do this for only one reason; the expectation of future super profits. Take away those super profits and you destroy the small Australian explorer.

The current situation is this: if the Federal Government maintains the 50 per cent Australian participation guidelines, then in any venture 60 per cent of the profits would accrue to the Federal and State Governments in the form of royalties and taxes and 20 per cent of the profits to Australian companies in the form of after tax profits. The remaining 20 per cent would go to overseas companies, of which a significant proportion would be ploughed back into Australia in the form of investments and continued exploration. Now this may not be as good as the 85/15 production sharing contracts in Indonesia but then Indonesia is an established oil province and exploration risks are somewhat lower there. In fact the introduction of a Resource Rent Tax may have the reverse effect to what the Government is trying to achieve, because it will sound the death knell for the small Australian explorer. If this happens, Australian participation in petroleum production may fall below 50 per cent and create a situation whereby the overseas content in these profits might actually increase. This of course will not occur because the Government will enforce the 50 per cent participation. How will it do this? — by the formation of a National Hydrocarbon Corporation.

This leads to an interesting situation. On one hand, the Liberal Federal Government seems to want to introduce a Resource Rent Tax and on the other hand, the Labor Opposition want to introduce both a Resource Rent Tax and a National Hydrocarbon Corporation. The argument put forward in this paper is that the introduction of a Resource Rent Tax will inevitably force the introduction of a National Hydrocarbon Corporation to fill the vacuum created by the destruction of the small Australian explorer.

The other major problem facing the small Australian explorer is the rapidly deteriorating equity market. Under the present market conditions, most companies could not even afford 5 per cent of the $120 million bid for W81-67 by the Occidental Petroleum Consortium, and this is only the tip of the iceberg. Australian exploration acreage has come of age and will not be acquired in the future for $2 to $6 per acre, which was the cost paid by one company with which this writer is familiar. Over the next few years and beyond, overseas companies will be pouring hundreds of millions of dollars each year into acreage applications in Australia. Not only small Australian explorers but even established producers and industrial companies will have difficulty in maintaining the 50 per cent Australian participation guidelines; and all this in the face of a declining equity market.

The Australian financial community is predicting a recovery possibly around the end of 1982, and internationally the present worldwide recession is predicted to turn around at much the same time. But what if it does not? Remember it took the Fraser

Government three years using Monetarist economic policies to reduce inflation in Australia from 16.3 per cent in 1974 to 7.8 per cent in 1978 and to improve the economy generally and gradually. If it is going to take a similar period for President Reagan's Monetarist policies to work, then the world is in for perhaps another two years of hard times.

What does this mean for the Australian exploration industry? Firstly, it means that there may not be a recovery in the equity market in late 1982 or perhaps even 1983. Secondly, the small Australian explorer, and perhaps even the established explorers may be unable to raise further risk finance. Thirdly, Australian exploration companies may be unable to maintain 50 per cent Australian participation in exploration in the face of increasing aggressive permit applications by overseas companies. The Government is then left with a dilemma; does it relax the F.I.R.B. guidelines or does it introduce a National Hydrocarbon Corporation? Politically it would be easier to introduce a National Hydrocarbon Corporation. Therefore the Australian Petroleum Exploration Community, while lobbying vigorously against the introduction of a Resource Rent Tax, should think about advising the Government on the most efficient structure of a National Hydrocarbon Corporation.

Firstly, it should be a non-operating exploration company designed to maintain 50 per cent Australian participation in all exploration and development permits. As such it need not swell into a 20,000 employee bureaucracy like the American Department of Energy. It should not compete for applications from a privileged position as did the British National Oil Company. It should not be acquiring overseas petroleum companies by the Federal Government printing money thereby fuelling inflation and devaluing the currency as has happened in Canada. No doubt it is probably too much to expect that such a simple National Hydrocarbon Corporation could be set up. However, if the equity market does not improve and if Legislation and Taxation amendments are not made to assist in the raising of risk finance for all Australian explorers, then the introduction of a National Hydrocarbon Corporation may be the only option left open to the Government.