SUBMISSION TO THE
INQUIRY INTO MICROECONOMIC REFORM IN WESTERN AUSTRALIA
BY THE ECONOMIC REGULATION AUTHORITY

13 December 2013

The DomGas Alliance

The DomGas Alliance was formed in 2006 to respond to consumer concerns about domestic natural gas supplies and pricing. The Alliance aims to promote security, affordability and diversity of gas supply for industry and households in Western Australia.

The members of the DomGas Alliance purchase around 80% of the gas produced for domestic use in WA and generate significant employment and economic opportunities for the State. Our members include Alcoa of Australia Limited, Alinta Energy, DBP (WA) Transmission, Verve, Gold Fields Australia Pty Ltd, Horizon Power and Newmont Mining.

This Inquiry

The DomGas Alliance submission relates solely to the ERA's question in relation to domestic gas reservation policy:

> *6. Should the State continue with the current Domestic Gas Reservation Policy? What are the costs and benefits of the current policy and any alternatives?*

The Discussion Paper also points to an earlier submission addressing this issue made by the ERA to the Inquiry into Domestic Gas prices by the WA Parliament's Standing Committee on Economics and Industry in 2011.

In quoting this submission in the 2013 discussion paper, the ERA gives a clear indication that it has already determined its position on the future of the domestic gas reservation policy, that being that it is "not effective, and would be inefficient if it were effective…consideration should be given to recommending that the policy be discarded."[1]

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[1] Discussion Paper, ERA, November 2013

From the Alliance's point of view, it is disappointing that this reference has been included as it confirms the ERA has taken an ideological position on this policy and is not open to alternative arguments about the merits of the policy and the benefits it has delivered the State and its people.

It is also disappointing that the Discussion paper casts the domestic gas reservation policy in a negative light with statements such as "the rationale for this policy is that the gas is likely to be sold at prices below those exhibited on the global market."[2]

This is, at best, a gross over-simplification of the policy and should not go unchallenged.

The domestic gas component of the North West Shelf State Agreement helped under-pin the development of that project. Subsequent to that, the State negotiated agreement for a domestic reservation of gas from the Gorgon project.

The more recent manifestation of domestic gas reservation policy emerged in 2006 under the former ALP government led by Premier Alan Carpenter. The policy rationale is clearly stated as *"ensuring that sufficient supplies of gas are available to underpin Western Australia's long term energy security and economic development."*[3]

In relation to the price of this gas, the 2006 policy clearly stated: *"the price of gas sold onto the domestic market will be determined through commercial negotiations between the gas producers and the consumers of that gas."*[4]

These views are again captured in the State Government's 2012 Strategic Energy Initiative which states; "Modelling conducted as part of the Energy2031 process has highlighted the risks associated with future domestic gas supplies, in terms of availability to meet local requirements and the pricing of such supplies. These risks reinforce the need for the continued application of the Domestic Gas Reservation Policy."[5]

These risks are confirmed by the real life experience of DomGas Alliance members who report facing significant challenges securing the gas supplies they need to sustain their existing operations in Western Australia, let alone unlocking any expansion potential.

Having noted that, the Alliance takes at face value the ERA's commitment that it "intends to take a pragmatic approach to this Inquiry".

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[2] ibid
[3] WA Government Policy on Securing Domestic Gas Supplies, October 2006, Department of Premier & Cabinet, Page 2
[4] ibid
[5] Energy2031: Strategic Energy Initiative, WA Government, October 2012

Domestic gas supply in Western Australia

Natural gas accounts for half of Western Australia's energy supply and 60% of electricity generation. A wide variety of Western Australian industry is critically dependent on competitively priced gas supply to sustain operations and compete in international markets.

However, despite Australia's (and particularly Western Australia's) massive gas resources this competitive advantage is being eroded as potential supplies are preferentially directed towards LNG export.

The emergence of Floating Liquefied Natural Gas (FLNG) technology has added a further dimension to this problem.

Even without FLNG operations, the medium to longer-term domestic gas market in Western Australia is delicately poised with significant supply shortfalls likely in future years. This is despite the Western Australia market having the benefit of a nominal 15% domestic reservation policy.

There is already clear evidence that rising domestic gas prices and uncertainty of long-term gas contracts are impacting Australian industry and eroding international competitiveness of Australian industry. This also has a dampening impact on growth by reducing the attractiveness for new projects and investment opportunities. For example, recently Incitec Pivot chose to invest $US850 million ($940 million) in a new ammonia plant in the United States instead of Australia, citing access to a reasonably priced supply of natural gas as one of the key reasons it shelved plans for an Australian facility.

The bottom line is that the massive expansion in LNG production for overseas markets, will at the same time see Western Australian industry and households staring down the barrel of an extra $3.1 billion in annual gas bills.[6]

This cost will be borne directly or indirectly by every business and household in the State.

The Western Australian market currently consumes around 1000 terajoules per day (TJ/d) of domestic gas. While almost 60% of this need is supplied by the North West Shelf (NWS) the supply from this project is expected to fall sharply during this decade, before ending in 2020 when long term domestic supply contracts expire.

Well before this date the Alliance believes that Western Australia will need to find ~700Tj/d in new domestic gas supply to replace the NWS project and to meet the estimated modest annual consumption growth of 2.5% per annum.

The question this poses is simple – where is the gas going to come from to fill the gap? Unfortunately the answer is far more complex and concerning.

The DomGas Alliance strongly believes in the mutually beneficial co-existence of LNG and domestic gas. The history of the development of the North West Shelf project is an illustrative example of this.

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[6] BREE, Energy in Australia 2012

The Alliance is concerned that the community support that has been vital to the development of the LNG industry in Western Australia could be significantly eroded if the community does not see a local benefit being delivered from our State's natural gas resources.

The Alliance is also concerned that the removal of the domestic gas reservation policy would be a backward step which would tilt the market even further out of balance to the detriment of Western Australian jobs and domestic economic growth opportunities.

The unintended consequences of unrestricted LNG exports at the expense of domestic energy security have been analysed by the National Institute of Economic and Industry Research which found that for "each petajoule of natural gas that is shifted **away** from industrial use **towards** export, whether because of tight supply or uneconomic pricing, means giving up $255 million in lost industrial output for a $12 million gain in export output. That is, for every dollar gained $21 is lost. This increases to $24 when economy-wide impacts are taken into account."[7]

The findings of this analysis strongly indicate that an "open slather" approach to LNG exports of WA gas at the expense of domestic supplies would result in a significant loss of economic value and manufacturing jobs to the State.

Is the current domestic gas reservation policy working?

The ERA has previously stated its view that "the reservation policy is generally recognized as not being effective", a view it repeated in its current discussion paper.

This is consistent with the view expressed by gas producers and their representative body, the Australian Petroleum Production and Exploration Association (APPEA).

It is reasonable to argue that the policy has not resolved all of the issues facing domestic supply but it does not logically follow that this means the policy has not been effective.

An analogy would be to ague that because around 20% of the State's road fatalities involve alcohol-affected drivers, the State's policy commitment to Random Breath Testing has not been effective and should be discarded. Clearly the policy has not fully resolved the issue of drink driving but it has led to a significant reduction in the incidence and impact of this behaviour. If the RBT policy commitment had not been in place, alcohol-related deaths would have been much higher.

[7] Large scale export of East Coast Australia natural gas: Unintended Consequences, The National Institute of Economic and Industry Research, October 2012

In other words, critics of the performance of the domestic gas reservation policy ask the wrong question: has it fully solved the issues surrounding domestic supply security? And having asked the wrong question and having been able to answer in the negative, satisfy themselves that the argument is for discarding the policy is self-evident.

The DomGas Alliance agrees that changes could be made to make the reservation policy work more effectively. This, however, does not mean the policy has not been making a positive contribution to date.

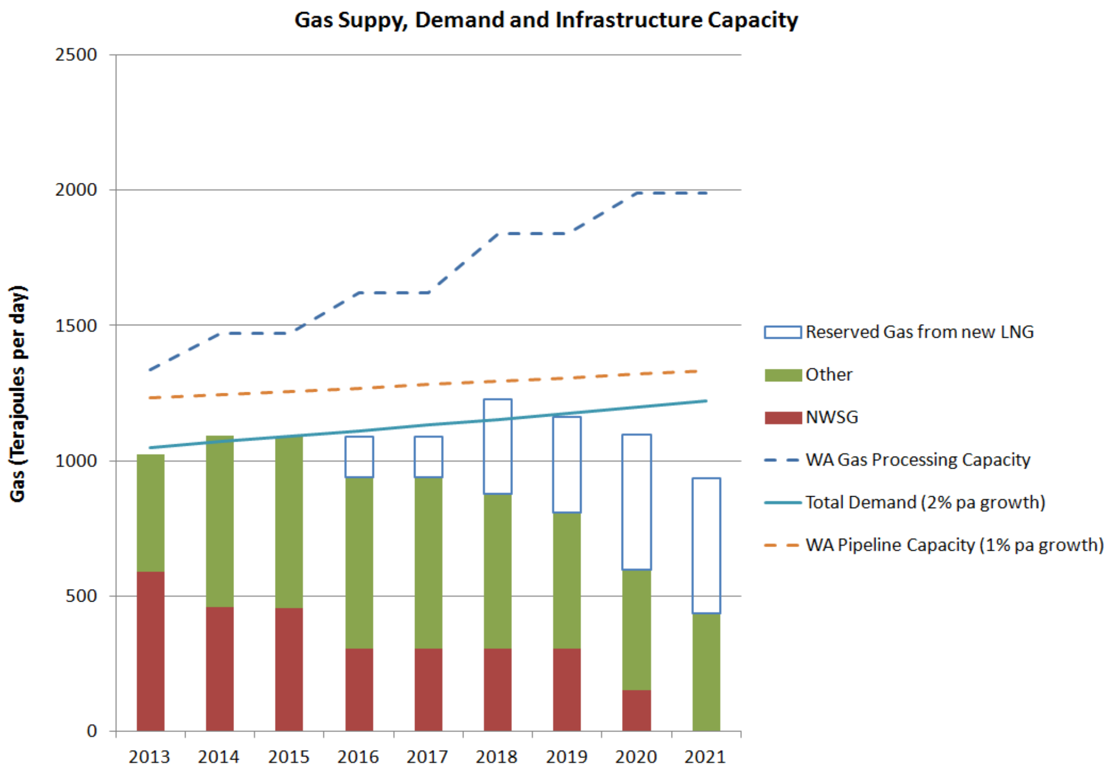
A fair assessment of the value of the policy to date is found in the question: would the outlook for domestic supply to 2020 be better or worse if there had been no domestic reservation policy in place from 2006?

Currently the Gorgon and Wheatstone projects are understood to be the only near to medium term developments which have uncontracted offshore gas.

Even with these projects delivering some gas into the domestic market, it is likely supply will not meet demand (in fact they do not fully off-set the expected decline in NWS output). The consequence of this will be a slow-down in State growth, the real likelihood that local industry will continue to pay some of the highest prices for gas in Australia, amongst the highest prices of any gas exporting country in the world, and the possibility of supply shortfalls.

As noted, critics of the domestic gas reservation try to paint this as an illustration of the policy not working. However without the domestic reservation requirements applied to the Gorgon and Wheatstone projects, there is little question that what is currently a very tight market for domestic gas would in fact become an alarming shortfall in supply.

The following chart graphically illustrates this with the reserved gas from Gorgon and Wheatstone helping to bridge the gap between supply and domestic demand as the output of the North West Shelf inevitably begins to taper off.



The current *Inquiry into the Economic Impacts of Floating LNG Operations* being conducted by the Standing Committee on Economics and Industry has helped highlight the importance of the domestic reservation policy while at the same time highlighting the intellectual weakness of arguments that the policy has not been effective.

Committee member, the Hon Fran Logan MLA, asked APPEA:

> **"**Just to pick you up on that, the IMO has indicated that in the future, in their view, there will be a full volume of domestic gas that would meet market demands, but they include in that Wheatstone and Gorgon, which was achieved by the 15 per cent reservation rule. If you did not have that in place—you are arguing that case, you are arguing it should be withdrawn— name me one project that is going to then provide the gas that Western Australia needs, given that all the projects that are being put before the committee are all FLNG and provide no domestic gas."[8]

Despite repeated questions to this effect, APPEA could not provide examples of projects which could have filled the serious domestic supply gaps which would have emerged in the absence of a reservation policy.

The argument put forward by APPEA and others that the free market will somehow "sort it out" simply cannot be sustained nor justified, given the significant risk this would pose to Western Australian industry and jobs.

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[8] *Inquiry into the Economic Impacts of Floating LNG Operations*, WA Standing Committee on Economics and Industry, 1 November 2013

The chart shows that even with domestic reservations, there is a potential shortfall between supply and demand as early as 2016. This starts to widen significantly in 2020. It should be noted that if the proposed domestic gas start-up for Gorgon (2016) is delayed, then the shortfall in supply for that year could significantly widen. If Wheatstone faces similar delays, then the potential over-supply in 2018 would become a shortage of supply.

As noted previously, FLNG has the potential to make the State's domestic gas situation significantly more challenging.

This chart shows that even with Wheatstone and Gorgon, there is a widening supply gap from 2020 and beyond. It had always been assumed that this gap would be met, at least in large part, by domestic gas that would have been delivered under reservation from the Browse and Scarborough projects. The joint venture partners for Browse have announced the project will now be delivered by FLNG. While a final concept selection for the delivery of Scarborough has not yet been made, the joint venture partners have signaled that "floating LNG is considered the best option for developing Scarborough at this stage."[9] These decisions suggest that strong consideration needs to be given to strengthening the domestic gas reservation policy through the adoption of a similar approach from the Commonwealth.

Does the domestic gas reservation policy discourage exploration and investment?

Major gas producers and their representative body, the Australian Petroleum Production and Exploration Association (APPEA) have maintained that domestic gas reservation is a threat to international competitiveness and has the potential to make projects uneconomic.

The Deloittes - Access Economics report, *"The Economic Impacts of a Domestic Reservation"* – commissioned by APPEA and referenced in the ERA Discussion paper – adopts the same position.

The Deloittes – Access Economics report makes the surprising claim that "the impact of the Western Australian scheme is still emerging" – despite being in effect since 2006 with continued strong investment in exploration and new projects since that time - and instead relies on the vague assertion that "experience from overseas indicates that policies of this ilk have a variety of adverse, unintended consequences."[10] The report does not provide any references to confirm these alleged overseas negative experiences.

This viewpoint is simply not supported in a Western Australian context by the data nor by practical experience to date.

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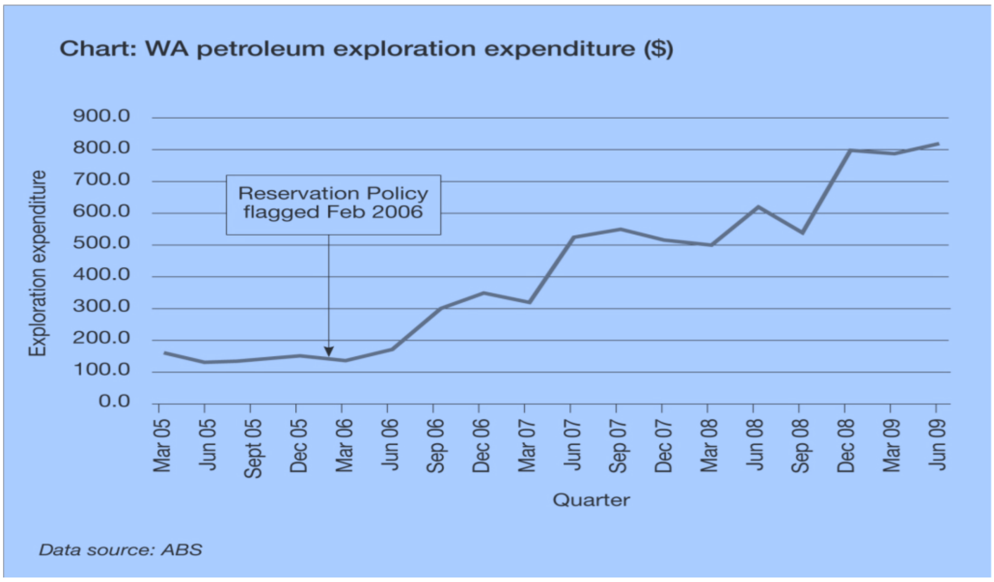
[9] "BHP says Scarborough tracking well." The Australian, 26/9/13

[10] *The economic impacts of domestic reservation*, Deloitte Access Economics, October 2013

The graph below shows that investment has continued to grow with recent projects such as Wheatstone, Gorgon and Pluto in an environment where the domestic obligations were well known and no doubt factored into the decision making process.



The robust health of the industry in 2009, three years after the formal policy was first flagged, was confirmed by the ERA itself in its submission to the 2011 Inquiry into WA Domestic Gas Prices by the Economics and Industry Standing Committee.

That submission stated; “Exploration in the petroleum sector has also stood up well following the global financial downturn” and went on to note “A total of 89 wells were drilled during 2009 with a success rate of 26 per cent for significant discoveries. A number of major international corporations have taken up exploration acreage and commenced significant exploration programs in Western Australia. In addition, established operators in the State have increased their exploration activities resulting in a number of sizeable gas discoveries in offshore northwest Australia.”[11] These would be the same operators who now claim the reservation policy is a disincentive to investment.

The ERA submission concluded “The information available on exploration and development of natural gas in Western Australia indicates strong economic activity in this sector in spite of a general downturn in activity more generally. While this activity is in all probability mainly focussed on LNG, there appears to be renewed interest in serving the State’s domestic natural gas market.”[12]

The current Inquiry into the Economic Impacts of Floating LNG Operations by the Economics and Industry Standing Committee heard evidence from numerous gas producers.

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[11] *Submission to the Inquiry into Domestic Gas Prices*, ERA, July 2010
[12] ibid

As previously mentioned, the advent of Floating LNG technology will effectively allow producers to bypass the domestic reservation obligation. The Committee was particularly interested in why floating LNG was being chosen as the delivery option over the traditional on-shore facilities. What was noteworthy from the oral evidence presented to the Committee was the almost complete lack of reference to the domestic reservation policy by the gas producers as being a factor in their decision-making.

In one sense, this should not be surprising. As the DomGas Alliance has consistently pointed out, Australia is the only country in the world that allows international oil companies to access and export natural gas without prioritizing local supply.

The major gas producers operate in a global environment where domestic reservations or export restrictions are commonplace. As has been recently reported, Woodside – the operator of the proposed floating LNG Browse project – is seeking to invest in the Leviathan project in Israel. Woodside CEO Peter Coleman was reported as saying: "It was pleasing to receive notice during the half that the government of Israel has maintained its domestic gas reservation for Leviathan at 50%, despite an aggregate increase in reservation volumes for all fields to 60% This delivers on the original policy setting for Leviathan on which Woodside based its investment."[13]

So it is clear that gas producers are comfortable with investing in projects where national governments expect a national interest benefit to accrue to their economy.

In a Western Australian context, this level comfort was underlined by the comments to the Committee by Chevron Australia managing Director Roy Krzywosinski who stated:

> "First of all, let me say this: it is important when companies make decisions to understand the parameters of the investment. Whether it is domestic gas or whatever other requirements might be out there, you need to understand the demands of the investment. You need to understand how that money will be used and so on and so forth. We understood that situation for Wheatstone. *We went into that investment with eyes wide open that there would be a domestic gas reservation policy. As a result, we are doing it; we are providing domestic gas. Between Gorgon and Wheatstone there is 500 terajoules a day, as you mentioned. That represents probably over 40 per cent, probably close to 50 per cent, of the current market. That is good news—there is more domestic gas, more competition. It is good news for everybody*."[14]

In addition to these comments, the operators of the Browse, Prelude, Scarborough and Ichthys projects were given the opportunity to comment on the rationale for their investment decisions.

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[13] "Woodside prepared to be patient on Leviathan", 22 August 2013, http://www.globes.co.il/serveen/globes/docview.asp?did=1000874205

[14] *Inquiry into the Economic Impacts of Floating LNG Operations*, WA Standing Committee on Economics and Industry, 24 October 2013

While the Committee was told the decision to send Ichthys gas to Darwin rather than bring it on-shore in Western Australia was based on the lack of certainty of availability of land, the proponents of the Browse, Prelude and Scarborough projects all identified capital cost as being the driving force behind their decisions.

The views of Woodside – as the operator of the proposed FLNG Browse project – are particularly insightful here. Woodside Executive Director Rob Cole told the Committee:

> "As I said earlier, it is not a binary decision where it is a go–no go against one metric; we do look at an array of different considerations—risk, capital intensity, sensitivities and so on. We spent two years studying it. *The key variable here, though, is the capital cost.* I mentioned earlier that capital costs have grown almost exponentially over the past five or six years, and that was a key metric that really depressed the economics of the project." [15]

Mr Cole went on to point out that these costs pressures were not primarily domestic:

> "… the first point I would make is that the local construction costs were only a percentage of the overall costs of the project. I am not sure exactly what percentage of the overall cost of James Price Point was in fact overseas cost versus local cost, *but the vast majority is in fact overseas cost.* We are not talking about costs just rising in Australia; costs have risen globally in this industry right around the world. When you look at the cost of LNG, it might be 70 to 80 per cent is in fact an international cost that has risen." [16]

Even APPEA's Director of Economics, Damian Dwyer, pointed to costs as being the key driver in Australian LNG's international competitiveness:

> "If Australia convinces operators to develop LNG facilities here in Australia, and Western Australia in particular, rather than in East Africa or North America, the landed costs of LNG to Asia need to be competitive with those alternative destinations. The McKinsey and Co analysis that we will share with you shows for a variety of reasons that the landed cost to Japan of Australian LNG going forward is around 20 to 30 per cent higher than a potential North American competitor. *So, Australia has a relative disadvantage in costs, driven primarily by higher taxes, labour productivity costs, materials and freight, and equipment and infrastructure specifications*." [17]

In short, while the domestic gas reservation policy has become a convenient whipping boy or bogeyman for gas producers and their representative body, it is clear that it is not a significant factor in decision-making by gas producers.

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[15] ibid, 16 October 2013

[16] *Inquiry into the Economic Impacts of Floating LNG Operations,* WA Standing Committee on Economics and Industry, 16 October 2013

[17] ibid, 26 June 2013

The continued strong investment in petroleum and gas exploration in Western Australia, the continued movement of companies related to the industry to Perth and the development of projects such as Gorgon, Wheatstone and Pluto under a domestic gas reservation obligation are all evidence that the current Western Australian policy is not having a detrimental impact on the oil and gas sector in our State.

At the same time it is providing a degree of support to domestic gas users who require certainty of supply of competitively priced gas as an energy source to under-pin long-term investments in the States economy.

The onus is clearly on those who wish to discard the domestic gas reservation to detail how domestic demand would be met in its absence, how the State would be compensated for the loss of economic activity and jobs in the manufacturing sector, and how Western Australia would avoid the economic and social consequences of an open slather approach to gas exports.