



## **PRODUCTIVITY COMMISSION DRAFT REPORT ON THE PETROLEUM SECTOR: ALLIANCE RESPONSE**

### **1. Overview**

In December 2008, the Productivity Commission released its draft report on the *Review of Regulatory Burden on the Upstream Petroleum (Oil and Gas) Sector*. The Alliance's response focuses on the Draft Report's findings relating to:

- Improving regulatory approvals processes and timeframes;
- Incentives to invest in exploration and development;
- Retention Lease arrangements; and
- the WA Government's domestic gas reservation policy

### **2. Improving regulatory approvals processes and timeframes**

The Alliance supports the overall intent of the Draft Report findings on the need to improve regulatory approvals processes and timeframes to facilitate exploration and development.

The current approvals process and stringent demands placed on developments create significant barriers to entry for new players and serve to protect larger incumbent producers.

While efforts have been made in this area, there are opportunities for further streamlining of State and Federal approvals processes for new projects. The Alliance therefore supports a review of existing approvals processes to identify opportunities for further streamlining.

### **3. Incentives to invest in exploration and development**

While the Draft Report's focus has been on reviewing regulatory burden on producers, the Draft Report correctly calls on governments to enhance incentives to invest in exploration.<sup>1</sup>

A recent study undertaken by the Alliance recommends that Commonwealth and State governments implement a range of tax, royalty and other investment

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<sup>1</sup> Productivity Commission, *Draft Research Report*, p.86.

initiatives to encourage exploration and development of gas fields for domestic supply. These include:

- Commonwealth – State grants to support new domestic gas developments;
- State royalty concessions, such as royalty holidays or reduced royalty rates, for domestic gas developments;
- Increased Federal tax deductibility for pre-wellhead expenses incurred by domestic gas developments; and
- Flow Through Share Scheme for domestic gas exploration and development companies.

The study found such incentives could promote smaller domestic gas developments, or LNG projects with a domestic gas component. This will help balance the incentive under existing tax and royalty arrangements to develop the State's natural gas resources as large scale LNG projects, and the oil and gas industry's current focus on LNG exports.

Incentives could also encourage new frontier technical challenges such as onshore "tight gas" fields. Tight gas developments involve additional technology and significant pre-wellhead expenses compared to conventional fields. Increased deductibility of pre-wellhead expenses could for example promote field development and unlock a new energy source for Western Australia. The State potentially has 9-12 trillion cubic feet (Tcf) of tight gas resources in the Perth Basin, located close to existing gas pipeline infrastructure.

Such incentives are particularly important in a significant economic downturn. In the current economic climate, inshore and onshore exploration activities – which are the most likely sources of competitive domestic gas supply – are impacted to a far greater extent than deepwater offshore exploration. This is because the companies involved are reliant on regular injections of risk capital from the local market. The consequences for future domestic gas supply of inadequate support for domestic exploration are, therefore, potentially extensive. A copy of the Alliance study is provided.

#### **4. Retention Lease arrangements**

The Alliance does not support the Draft Report's recommendations for "lighter handed regulation" in the administration of Retention Leases, and for extending lease periods from the current five years to 15 years. In the Alliance's view, these recommendations do not reflect the object of Australia's Retention Lease system or the current domestic gas market.

## ***Australia's Retention Lease system***

Section 38B of the *Petroleum (Submerged Lands) Act 1967 (Cth)* provides for the grant of a retention lease over petroleum discoveries. A retention lease may be granted where a petroleum discovery proves to be currently non-commercial but has the potential to become commercial within 15 years. While the initial term of a Retention Lease is five years, this may be renewed provided it still meets the required uncommerciality criteria. Under the Act, a Retention Lease must be converted to a Production Licence when a reserve is commercial.

The object of the Retention Lease system is to encourage and facilitate exploration, investment and development of Australia's petroleum resources, while at the same time ensuring resources are developed in an appropriate timeframe, and in a manner that meets the needs of the local community.

It seeks to achieve this balance through the commerciality requirement. The grant of a Retention Lease protects the interests of upstream companies that discover gas resources that are not commercially viable in the short to medium term. Where however resources become commercially viable, they must be developed.

Accordingly, the Act does not permit the "parking" of commercially viable gas resources for development at a time most convenient to the lease holder. Nor does it distinguish between whether a resource can be commercially developed for domestic gas or for LNG export. This means that producers cannot withhold otherwise commercial resources from supplying the domestic market, or develop in sequence reserves most profitable for LNG export.

Given the object and requirements of the Act, it is unclear to the Alliance what the Draft Report's recommendation that government review of Retention Leases be "light touch" would entail. To the extent this suggests government should not enforce the provisions of the Act and stringently apply the commerciality requirement, this is strongly opposed by the Alliance.

The Draft Report also considers that companies that have invested heavily in exploration would be motivated to develop any discovered resources if they are commercially viable. The Report considers that other companies have more optimistic views about commerciality, then a private transaction between companies would seem to be a likely outcome.

The Alliance believes these conclusions do not fully take into account the commercial interests and motives of producers, which the Act seeks to balance. The drive to maximise profits can result in producers "parking" reserves indefinitely, or developing in sequence resources that are most profitable. There is also an incentive to aggregate gas fields for increasingly massive LNG export developments, rather than supply the domestic market. The Act seeks to

balance these narrow commercial interests with the broader needs of the local economy, including the timely development of gas resources owned by the Australian community. The Act's object is not simply the maximisation of producer profits.

It is also unrealistic to consider that where other companies have more optimistic views about commerciality, then a private transaction between companies is a likely outcome. This understates the fact that different companies have different commercial motives, drivers and hurdle rates of return – which might not be reconcilable through a “market price” transaction.

An example is where a large LNG producer holds a resource that is otherwise commercial to develop as a domestic gas field, but which the producer is withholding indefinitely so it could be developed as part of a larger LNG project. In this example, it could not be assumed that a small domestic gas company will be able to arrive at a private transaction with the large LNG producer to access the resources. Even if a price could be placed on the transaction in terms of the potential lost opportunity from a future LNG project, this is likely to be prohibitive for the domestic gas company.

The Alliance also notes that the commerciality test is a long standing requirement of Australia's Retention Lease system. Given producers have long been aware of the requirements of the Act, the Alliance questions the Draft Report's finding<sup>2</sup> that enforcing the Act – which expressly imposes a “use-it-or-lose-it” approach – could act as a disincentive to explore.

The object of Australia's Retention Lease system was affirmed by the Joint Working Group on natural gas supply, which included the Commonwealth as well as all State and Territory governments. The Joint Working Group report affirmed that in the granting and renewal of Retention Leases, the commerciality test should be “rigorously applied and enforced”.<sup>3</sup>

The Alliance supports the Joint Working Group report's recommendation for stringent enforcement of the Act. Retention Leases should not be used by producers to withhold gas that could otherwise supply the domestic market on a commercial basis.

Further, the Alliance has recommended that in the first instance, reserves held under Retention Leases should be assessed to determine whether they are capable of supplying the domestic market on a commercial basis. The Alliance also supports amendment of the administrative guidelines or legislation to further reinforce this expectation.

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<sup>2</sup> Productivity Commission, Draft Research Report, p.86.

<sup>3</sup> Final Report of the Joint Working Group on Natural Gas Supply, September 2007, p.32.

### ***The Draft Recommendations do not reflect the current domestic gas market***

As the Commission is aware, Western Australia continues to experience a serious shortage of domestic gas supply. Current and prospective gas users have been unable to secure long term gas supplies in substantial quantity. The price of such short term gas that is available has risen dramatically.

According to press reports of recent contracts, WA wholesale gas prices have risen five-fold over the past 18-24 months, with prices reported for recent gas sales in WA around five times Eastern States prices on a delivered basis. This is despite Western Australian gas customers being adjacent to the majority of Australia's gas resources.

Facilitating gas development is therefore critical to addressing the current gas shortages and escalating prices. Given the bulk of WA's gas reserves are currently held under Retention Leases,<sup>4</sup> ensuring timely development of such resources is vital. The Alliance opposes changes to the current lease periods that would further permit producers to withhold supply. The Alliance opposes the Draft Report's recommendation to extend lease periods from the current five years to 15 years, with renewals for a period of 10 years. If adopted, this will have a significant impact on timely development of gas resources and will further contribute to WA's gas shortage.

The Joint Working Group recognised the important role that Retention Lease administration must play in meeting WA's gas shortages. In particular, the Joint Working Group:

“[R]ecognises that the market environment has changed significantly in recent years. As a result, there is an expectation that the prospects for commercializing many known gas resources have improved substantially. In these circumstances it would appear appropriate for the Joint Authority to review existing gas retention leases, implement a more transparent application of existing guidelines, and, where considered appropriate, to request a re-evaluation of commercial viability in accordance with s38H of the Petroleum (Submerged Lands) Act.”

“The JWG supports further investigation into improving the current acreage management process, in particular the granting and renewal of retention leases to ensure that processes are transparent and that tests of commerciality are rigorously applied and enforced ...”

The Alliance strongly supports the Joint Working Group's recommendations on Retention Leases.

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<sup>4</sup> 60% of WA's P50 gas reserves are held under Retention Leases. Only 14% of gas reserves are developed resources. Source: Department of Industry and Resources, *Petroleum in WA Magazine – September 2008*, pp.38-42.

### ***Need for greater transparency and opportunity for third party participation***

The Alliance supports the Draft Report's Draft Finding 5.4 that the current retention lease process lacks clarity and transparency for both applicants and other parties wanting to participate in the process.

The current process provides little transparency or openness. There is no gazettal system which would make public the substance of a Retention Lease application, the stage in the process that a particular application is at, or the reasons or basis for the Designated Authority's decision. The current process therefore provides an asymmetry of information that limits participation of other interested stakeholders.

This contrasts to existing State and Commonwealth environmental approval processes for development projects. These processes provide for transparency and significant opportunity for stakeholder input.

Greater transparency and disclosure in the process will: improve the underlying basis of Retention Lease decisions; encourage third party participation; subject applicant claims and assumptions to greater scrutiny and contestability; strengthen the application of the commerciality test; and promote opportunity and field development.

The robustness of Retention Lease decisions can be improved by providing for independent peer review or third party assessment of the Government's Joint Technical Report. This will also promote confidence and transparency in the process.

The Alliance recognises that lease holders may raise commercial information and confidentiality concerns. Such concerns should be manageable and, in any event, should not override the objects of the Retention Lease system.

Accordingly, the Alliance recommends:

- A public, on-line registry of State and Commonwealth retention leases should be established.
- The registry should provide clear indication on the current status of a particular Retention Lease application, the step in the process, etc; as well as identify Retention Leases coming up for review.
- There needs to be a public announcement when the Designated Authority begins its process of review.

- The general parameters or assumptions used by the Designated Authority to test “commerciality” should be publicly disclosed. This could be achieved by publishing an assumptions or data book identifying key factors such as prices, local demand, rate of return, expectations on CAPEX / OPEX, etc.
- Expert reports commissioned by the Designated Authority into matters such as market conditions, construction costs, etc, should be published.
- The Government’s Joint Technical Report should be published.
- There should be a review period allowing third parties to submit information in relation to the assessment parameters used by the Designated Authority, the assumptions and development concepts being advanced by the proponent, or to reinforce or challenge the Designated Authority’s draft decision.
- Opportunity should be provided to third parties to have input into the establishment of conditions for the grant or renewal of Retention Leases.
- The reasons and substance of the Designated Authority’s decision should be published.
- There should be an independent peer review or third party assessment to review and validate the Joint Technical Report, and to test the assumptions and conclusions made.

## **5. Domestic gas reservation**

The Alliance does not agree with the Draft Report’s Draft Finding 5.5 that the WA Government’s domestic gas reservation policy could in practice negatively affect exploration and development of both liquefied natural gas and domestic gas projects.<sup>5</sup> This finding does not reflect the history of the WA gas market, or the current market structure and conditions.

### ***Gas reservation is a long-standing feature of the WA gas market and underpinned the original NWS project***

The Draft Report’s finding that a gas reservation policy could discourage gas development does not reflect the 30 year experience of gas development in Western Australia.

Domestic gas reservation is an established and long-standing feature of the WA gas market. The original 1979 North West Shelf Gas State Agreement included a provision that required a fixed amount of the gas reserves from the project to be reserved for domestic use. This committed the North West Shelf Joint

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<sup>5</sup> Productivity Commission, *Draft Research Report*, p.89.

Venture parties to the supply of domestic gas to SECWA of up to 10.5 million cubic metres per day (or 414 TJ/d) over 20 years. The proposed Gorgon development on Barrow Island also includes a domestic gas reservation requirement in its State Agreement.

Importantly, it was the domestic market – through the original SECWA take-or-pay contract – that enabled development of the original North West Shelf project, and the subsequent development of the LNG export industry. The domestic market provided stable long term returns that underpinned the development and expansion of the project.

Claims by gas producers that a reservation policy operates as a disincentive to invest should also be treated with caution. Australia remains one of a very small number of countries that allows unrestricted exploitation of national gas resources by private ownership interests. A report by Curtin University found that over 90% of the world's natural gas resources are directly or indirectly controlled by national oil companies. Only 8% of world reserves are open to full access by international oil companies.

Australia, with 2% of the world's gas resources, therefore represents *a quarter* of the total world resources available to international oil companies on an open basis. Requiring producers to supply a limited proportion of production to the local market is unlikely to discourage exploration and development in Australia.

### ***Gas reservation supports long term energy security and economic development***

The Draft Report does not fully reflect the importance of gas reservation in supporting long term energy security and economic development. While gas reservation alone would not address the current and long term challenges of gas supply, it recognises the public interest risks from the unrestricted exploitation or contracting out of the State's limited gas resources for LNG exports.

To that end, domestic gas reservation helps ensure sufficient supplies of gas are available to meet the needs of the local economy for the long term. It provides industry long term certainty to support investment in infrastructure development or new resource development projects.

For example, the Dampier to Bunbury Natural Gas Pipeline is subject to a regulatory regime that sets regulated returns on the basis of a 60 year assumed asset life. Having certainty over long term supply of domestic gas is therefore necessary to underpin investment decisions on pipeline expansion.

Domestic gas security is especially vital for Western Australia given the State's dependence on ongoing supply. Western Australia is the most energy and gas-dependent economy in Australia. Natural gas supplies more than half of WA's

primary energy requirements. Natural gas also fuels at least 60 percent of the state's electricity generation.

At the same time, Western Australia has only limited reserves of gas. Only 17% of WA's natural gas resources relate to developed fields. The bulk of resources are currently located deep offshore and have gas quality issues. There is no certainty that it would be economic to develop gas from remote reserves for the domestic market.

Contrary to claims by producers that Western Australia has "vast" or "over a hundred years" reserves of gas, the total existing resources in the Carnarvon Basin face being fully depleted within 30 years. Further, if government and producer export targets of 50-60 million tonnes per annum of LNG are reached, the total existing resources of the Carnarvon Basin will be fully committed by 2015-2020. Once committed to long term LNG contracts, gas is unavailable to meet current and emerging needs of the local economy.

A gas reservation policy is therefore necessary to ensure energy security, and to balance the drive to LNG exports with depletion of gas reserves and the long term needs of the local economy. It cannot be assumed, as the Draft Report does, that commercial imperatives would always see the domestic market fully supplied. Where a producer locks-up a gas field to a 25 year LNG contract, those resources are unavailable to local consumers for the 25 year life of the contract. This will be the case even if local consumers are subsequently in a position to pay higher prices.

It is important to note that WA's gas reservation policy is not unique. The Curtin University report found that governments around the world are acting to ensure long term domestic gas security. Other countries with significant gas reserves are introducing policies to ensure that their domestic requirements are adequately provided for. The fact that WA maintains a gas reservation policy – and has done so for the last 30 years – is unlikely to pose a disincentive to international oil companies.

### ***Absence of a competitive market***

The Draft Report makes the assumption that current domestic gas users are unwilling to pay prices that would leave an LNG exporter indifferent between supplying the domestic market or exporting LNG, and that gas reservation results in a subsidised domestic gas price.<sup>6</sup> It is disappointing that in making this assumption, the Draft Report fails to consider the history of the WA gas market, or the current market structure and conditions.

The original North West Shelf gas reservation and SECWA domestic gas contract was not a "low priced" contract and did not result in "subsidised" gas

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<sup>6</sup> Productivity Commission, *Draft Research Report*, p.89.

prices for consumers. Two-thirds of the gas was priced against high-priced Collie coal, with one-third priced against imported oil. This high pricing structure continued until the contract was disaggregated in 1995, when new supply competition from Apache helped put some downward pressure on prices.

Notwithstanding the entry of Apache and other producers, the West Australian market remains highly concentrated with current market structures ensuring the absence of a competitive market. As the Alliance noted in its original submission to the Commission, the North West Shelf Joint Venture producers – which supply almost 70% of the domestic market - currently sell gas to domestic customers through a joint selling entity North West Shelf Gas. This arrangement forces gas consumers to deal with a single entity rather than with individual Joint Venturers. This significantly reduces the number of sellers and, as a result, competition in the domestic market.

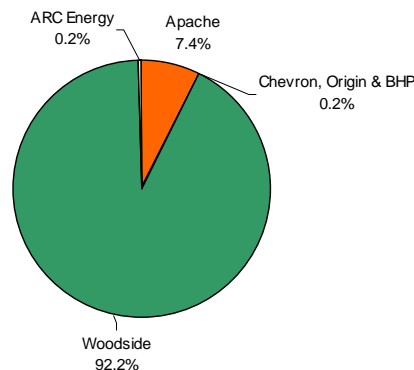
**Table: WA Domestic Gas Production by Project 2007**

| Project      | Operator | Tenement Owner/s                         | M cubic metres | % of Total |
|--------------|----------|--|----------------|------------|
| NWSJV        | Woodside | Woodside, BP, BHPB, Chevron, Shell, MIMI | 6,725,083      | 73.4       |
| John Brookes | Apache   | Apache, Santos                           | 2,229,814      | 24.3       |
| Other        | Various  | Various                                  | 214,209        | 2.3        |
| TOTAL        |          |  | 9,169,106      | 100.0%     |

Sources used: WA Department of Industry and Resources, *Petroleum in Western Australia September 2008*, pp.36 and 38.

The impact of joint selling is further exacerbated by the concentration in gas supply. Two operating entities (North West Shelf and Apache) supply close to 100% of the domestic market and control the developed fields that currently service the WA domestic market.

**WA Developed Gas Reserves by Operator <sup>7</sup>**



<sup>7</sup> Synergies Economic Consulting, *WA Gas Supply & Demand*, July 2007, p.88.

Far from enjoying “subsidised” prices, WA consumers are experiencing escalating gas prices. According to press reports of recent contracts, WA wholesale gas prices have risen almost five-fold over the past 18-24 months. Historically, wholesale prices for gas delivered to South West markets in WA (ie including transmission costs) have been around \$3.50-\$4.50 per gigajoule.

On a delivered basis, prices reported for recent gas sales in WA are also around five times Eastern States where a competitive market operates. Wholesale domestic gas prices in the Eastern States are around \$3-4 per gigajoule. For example, October 2008 price data published by Vencorp for the Victorian spot market indicates prices at around \$3-4 per gigajoule.

There are also indications that some producers are seeking more than “LNG-netback” prices, i.e. a premium return from domestic customers well in excess of that which could be derived from LNG exports. In October 2008, Santos announced a contract to supply gas to Moly Mines. The contract was stated to be for 33 petajoules of gas over six years with projected revenue of \$US 380 million (\$A 527 million). The gas price was linked to international oil prices. At the contract’s then assumed oil price of \$US 90 a barrel, this would have equated to \$16 per gigajoule for gas before transmission costs. This represents a significant premium to prevailing LNG contract prices, let alone “LNG-netback” prices.

The Draft Report’s assumption that domestic gas reservation is being driven by a desire by domestic gas users for “subsidised” gas prices therefore fails to reflect the history of the WA gas market, or the current market structure and conditions.

It also overstates the effect that a reservation policy might have on exploration and development. Given recent domestic gas prices, a requirement to reserve a portion of production to the domestic market is unlikely to operate as a disincentive to producers. Nor is it likely to make an otherwise viable and profitable gas field non-viable.

## The DomGas Alliance

The DomGas Alliance was formed in 2006 in response to a serious shortage of gas supply for new developments in WA. Membership includes current and prospective gas users and gas infrastructure investors.

Alliance members represent 80 percent of Western Australia's domestic gas consumption and gas transmission capacity, including smaller industrial and household users of gas. The Alliance also represents a significant proportion of prospective demand for additional gas supplies.

Members include: Alcoa of Australia, Alinta, Burrup Fertilisers, Dampier Bunbury Pipeline, ERM Power / NewGen Power, Fortescue Metals Group, Horizon Power, Newmont Australia, Synergy, Verve Energy and Windimurra Vanadium

The Alliance works closely with State and Federal Governments and other industry stakeholders to promote greater competition, diversity and security of gas supply for industry and households in WA.



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