DomGas Alliance

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Ms Wana Yang
Assistant Director Markets
Economic Regulation Authority
PO Box 8469
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Dear Ms Yang

2012 WEM REPORT - UPSTREAM GAS COMPETITION

The DomGas Alliance welcomes the opportunity to provide a submission to the 2012 Wholesale Electricity Market Report process.

The Alliance is the State's peak energy user group and represents gas users, infrastructure investors and prospective domestic gas producers. Alliance members account for around 80% of the State's gas consumption and transmission capacity, which includes the supply of gas and electricity to 800,000 households and 200,000 small businesses.

The lack of gas on gas competition and wholesale gas prices

The 2011 WEM Report identified "higher fuel costs, particularly given the lack of gas on gas competition to supply the domestic market and the high price of LNG" as a key driver of recent tariff increases.[1]

In the Alliance's view, joint selling arrangements and the absence of gas on gas competition is the biggest barrier to gas market reform in Western Australia. The wholesale gas market is anti-competitive and inefficient. Just two producer groups control almost 100% of the market and exercise immense market power through joint selling arrangements. The same producers also control the bulk of new projects that could supply the WA gas market.

Monopolistic gas pricing has driven significantly increases in wholesale gas prices and tariff increases for electricity customers. The joint selling arrangements prevent the development of a competitive, efficient and fair commercial environment.

[1] 2011 WEM Report, page x.

These same producers compete against each other when selling LNG to international customers. They are also prohibited from selling jointly in the United States, Canada, New Zealand and the European Union.

Joint selling authorisation by the ACCC

The ACCC has repeatedly intervened in the market to allow major gas producers to combine together to set prices and contract terms when selling to WA customers.

In 2009, the ACCC authorised Shell, Chevron and ExxonMobil to combine together to set prices and conditions for Gorgon domestic gas. In doing so, the ACCC dismissed its own independently commissioned report by Allen Consulting Group.

The ACG Report dismissed as "misleading", the Gorgon partners' claims that separate selling was not practical and that joint selling was necessary to underpin the Project. The Report observed that:

- Separate selling was already taking place in other gas projects in WA.

- Domestic gas represented less than 5% of the Gorgon gas resources and would account for less than 5% of expected revenue.

- The Gorgon partners were selling separately and competing with other when marketing 95% of Gorgon gas to overseas LNG customers.

- Domestic gas sales would be subject to take-or-pay contracts, with the risks largely borne by customers.

- Shell and Chevron were *already* participants in the largest domestic gas seller in WA, the North West Shelf Joint Venture, which already controlled some 70% of the market.

- Shell, Chevron and ExxonMobil were three of the largest companies in the world with combined 2008 income of $US 120 billion.

- ExxonMobil was the world's largest and most profitable oil and gas company.

The ACG Report concluded that while joint selling might reduce costs for producers, gas prices were most likely to rise "due to monopolisation effects". In contrast, separate selling would reduce the bargaining power of Shell, Chevron and ExxonMobil with the likelihood of lower gas prices. A copy of the Report is provided.

In 2010, the ACCC authorised the six North West Shelf Project partners to continue to combine together and set prices covering some 70% of the gas market. This was despite three State Government Departments advising the ACCC that requiring gas producers to sell separately would not threaten investment in the North West Shelf Project but would instead promote competition.[2] The ACCC's decision came shortly after five of the six North West Shelf partners combined together to impose a significant price rise on Alinta.

It should be noted that when authorisation was first granted in 1977, the North West Shelf partners were selling to a single State monopoly (SECWA). Since then, the downstream market has undergone significant reforms to improve competition and efficiency while the upstream market remains an effective duopoly.

The purported benefits to energy consumers from joint selling have not eventuated

In authorising the North West Shelf partners to continue to sell jointly, the partners and the ACCC asserted this would benefit consumers by promoting domestic gas supply.

These purported benefits have not eventuated. While the North West Shelf partners have enjoyed the benefits of monopolistic pricing arrangements, the Alliance is unaware of any new contracts being concluded with major gas customers to replace existing long term contracts.

Joint selling and cross-ownership suppresses competition between projects

The same producers control the major prospective gas developments in the State. Any gas on gas competition that might otherwise ensue from new projects will therefore be minimal.

Joint marketing decisions are typically made on a "lowest common denominator" basis which requires all producer participants to agree. Participants in one joint venture are unlikely to undercut prices in another joint venture which they are also participants in. Producers can also coordinate marketing across projects by ensuring projects are marketed sequentially and not in competition.

There is now increased alignment between the North West Shelf / Gorgon producers and the other major supplier to the WA domestic market, Apache. Apache and BHP Billiton are now joint owners of Macedon, and Apache is a joint partner with Chevron in the Wheatstone project.

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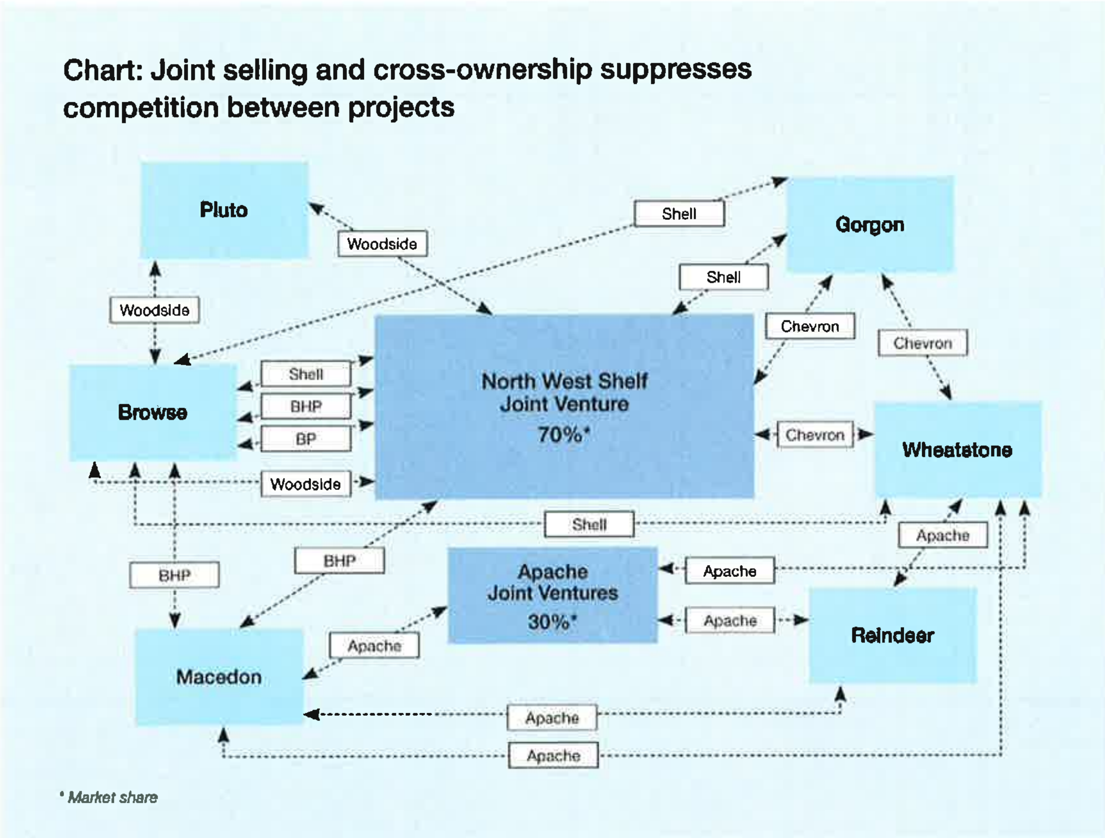
[2] ACCC, *NWS Project Applications for Authorisation A91220-A91223: Government of Western Australia Departments – Record of Meeting*, 1 June 2010.

The following diagram highlights the extent of cross-ownership in the WA upstream gas market.



The 2011 Parliamentary Inquiry Report

The 2011 Parliamentary Inquiry into Domestic Gas Prices Report highlighted the impact of joint selling arrangements on competition. The Report concluded:

> Prices that persistently reach or exceed LNG netback values reflect an absence of adequate competition and are inconsistent with a well functioning domgas market … (Finding 18)
>
> While arguments can be made in support of the continuation of joint marketing in the current Western Australian domestic gas market, it is plausible to claim that the practice has facilitated a reduction in competitive tension between gas producers. This may have contributed to the increasingly stringent contractual terms and conditions that some gas buyers have been reportedly facing and the higher prices being realised in this state. (Finding 27)

The Report recommended the end of joint selling arrangements when ACCC authorisations expire in 2015:

> The government should vigorously pursue the elimination of the joint marketing authority currently granted to the North West Shelf and Gorgon joint venturers when the applications come up for renewal in 2015. (Recommendation 13)

The issues merit examination by the ERA

Joint selling and the absence of gas on gas competition has resulted in monopolistic pricing and driven significant price increases for gas and electricity customers. Joint selling also frustrates the development of a competitive, efficient and fair commercial environment.

The Alliance believes the issues merit investigation by the ERA.

Yours sincerely

Gavin Goh
Executive Director