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Mr Lyndon Rowe
Chairman
Economic Regulation Authority
PO Box 8469
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Via email: publicsubmissions@erawa.com.au

Dear Mr Rowe

APPEA Comments: Inquiry into Microeconomic Reform – Draft Report

The Australian Petroleum Production & Exploration Association (APPEA) is the peak national body representing Australia's oil and gas exploration and production industry. APPEA has more than 85 full member companies exploring for and producing Australia's oil and gas resources. These companies currently account for around 98 per cent of Australia's total oil and gas production and the vast majority of exploration. APPEA also represents nearly 300 associate member companies providing a wide range of goods and services to the industry.

APPEA welcomes the opportunity to provide a submission to the Economic Regulation Authority's (ERA) *Inquiry into Microeconomic Reform in Western Australia (WA) – Draft Report*. APPEA's submission represents a broad industry view. APPEA's comments focus on Section 7.4 of the Draft Report, which considers the State's domestic gas reservation (DGR) policy.

Draft Report Findings

The ERA's recommendation to "*Rescind the domestic gas reservation policy as soon as possible*" is supported by APPEA and reflects the evidence presented to it by interested parties. The negative economic impacts of WA's DGR policy outlined in the *Draft Report*[1] far outweigh any perceived benefits to the WA economy that the policy may deliver.

Misuse of the Term Market Failure

In economics, the term market failure has a clear technical meaning which can be used to assess the different sides of the argument regarding domestic gas reservation. Three key aspects are worth emphasising:

- When markets are out of equilibrium, say because the economy is experiencing rapid growth, imbalances between supply and demand are typically a feature. The fact that some experience the consequences of that disequilibrium does not connote market failure: it is a necessary precursor for resolving imbalances. Suppressing these market signals will aggravate rather than resolve any imbalance.

- Even in an economy that is broadly in equilibrium, the fact that some believe that they are not getting as good a deal as they might does not mean there is market failure. For

[1] Page 311.

example, where high initial (sunk) costs are required to secure output, then if buyers could escape covering these costs, supply would never be forthcoming (absent public subsidies). That would constitute a market failure.

- Even where there are market failures, it does not necessarily follow that society would be better off seeking to correct the situation. All forms of government intervention involve costs, and those costs may exceed the efficiency benefits achievable from correcting the market failure. The risks and costs of 'government failure' need to be given no less weight in the assessment of policy options than those of market failure.

With that in mind, the ERA is correct in dismissing any claims from DGR proponents that a market failure exists in the WA domestic gas market.

Rather, the only "market failure" evident is the failure to let markets operate. A sentiment shared recently by the Hon Ian Macfarlane MP, Minister for Industry, who said "*In WA, if you ask anyone [about DGR], they'll tell you it's corrupted the market and affected supply.*"[2] As stated in APPEA's submission to the ERA's *Discussion Paper*, there is ample evidence that gas consumers can obtain gas supplies on commercial terms. Without such agreements, domestic gas projects like Devil Creek, Macedon and Red Gully would not have been developed.

One important area that the *Draft Report* does not address in detail is the impact of DGR policies on domestically-focused gas producers. The DGR policy provides a level of uncertainty for domestic gas producers whose development plans can be adversely affected by the sanctioning of an unrelated LNG project. It also delivers uncertainty for domestic gas explorers who must raise large funds for exploration expenditure in the face of uncertainties about "reservation gas" being "allocated" for the domestic market.

Importantly, it also brings uncertainty for gas consumers, who may defer from making commercial arrangements with domestic suppliers for gas on the prospect that "reservation gas" will be secured by government policy and be available on better commercial terms.

This uncertainty can be alleviated by the removal of the DGR policy.

Upstream Costs

The *Draft Report* on page 294 highlights that production costs are a key driver in the changing conditions of the WA domestic gas market. While this is correct, it is only one aspect of the cost pressures facing gas producers. These cost pressures extend across the gas value chain from exploration to development to ongoing production.

Proponents of DGR policies incorrectly point to increasing expenditure on exploration efforts following the introduction of the WA DGR policy, as evidence that the policy is not a disincentive to upstream producers. APPEA cautions against reliance on these "facts".

As indicated in Figure 1, annual expenditure on offshore exploration drilling is indeed increasing, however the number of exploration wells drilled offshore is in decline. This is clear evidence of the increasing costs of exploration activity. The average offshore exploration well now costs over \$130 million to drill. In 2003, the average cost was \$8.8 million. Exploration budgets are linked to work program licence obligations, often in three or four year cycles. The impacts of policy

[2] See: www.abc.net.au/news/2014-05-07/gas-reservation-policy-under-fire/5434384

decisions made today, for example, are often seen in the exploration sector three or four years later.

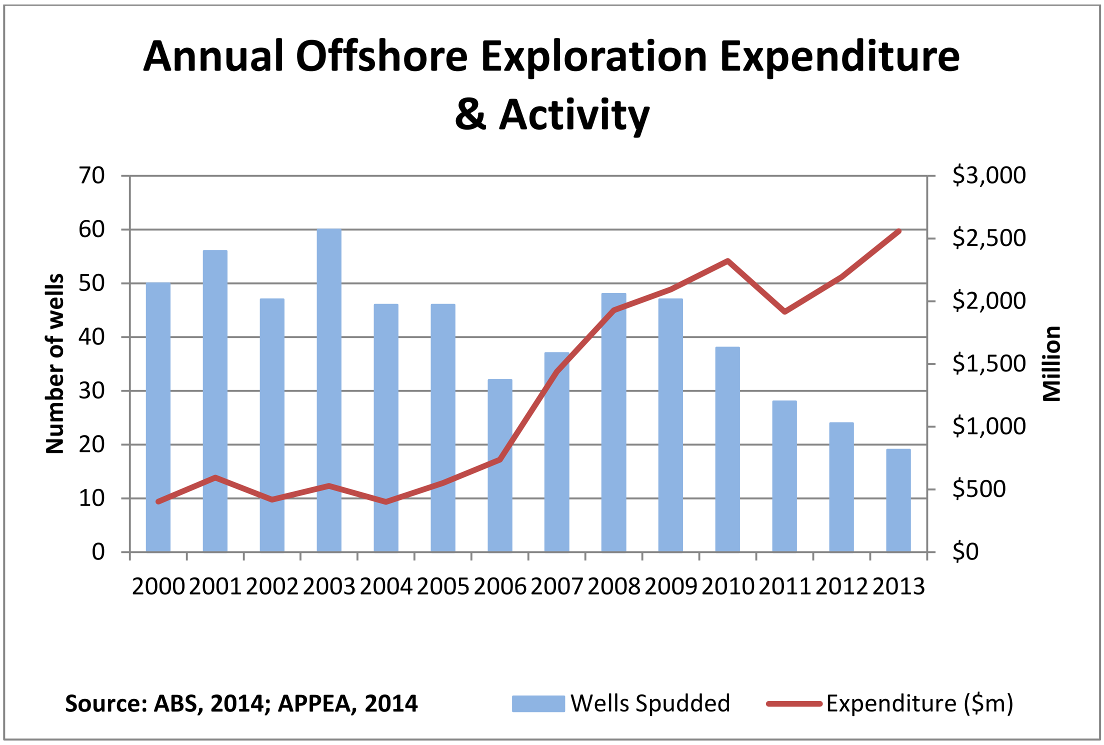

Figure 1: WA Offshore Exploration Expenditure & Activity

Similarly, Australia is at the top of the cost curve for bringing gas to market. As shown in Figure 2, Australian greenfield projects can be almost double the cost of new LNG competitors in East Africa, North America and other locations.

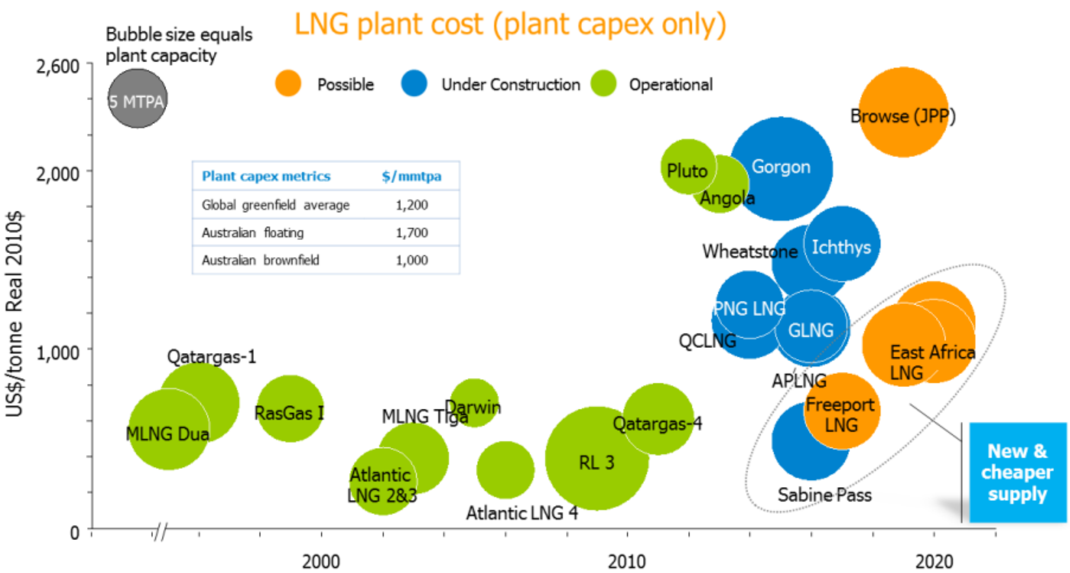

Figure 2: Santos, 2013, Global comparison of LNG plant capex costs

Cost challenges are not unique to the oil and gas industry; many Australian industries are facing global competitive challenges, most notably in specific sectors (for example automotive and aluminum) of the Australian manufacturing industry. Indeed Alcoa recently told a WA business forum that it was cutting jobs from its local operations and pushing all of its contractors to reduce their rates by 12 per cent to improve efficiency and productivity[3]. In this context, the most recent defence of the policy by the WA Department of State Development that "*Projects in this State continue to reach final investment decision…with a negotiated domestic gas commitment*"[4] is increasingly unrealistic given current cost pressures.

It is in this context, along with the other key drivers identified by the ERA in the *Draft Report*, that the WA domestic gas market is adjusting to new market fundamentals.

Economic Modelling

APPEA supports the general findings in the *Draft Report* and the ACIL Allen Consulting report, *Domgas Reservation Policy, Review of Literature and Policy Recommendations*, on the economic modelling conducted by both DGR opponents and proponents. It should not be surprising that the modelling techniques used appear to suit the parties commissioning the work. That said, both reports correctly identify complex general equilibrium modelling (CGEM) as providing more analytically robust modelling outcomes and treatment than basic input-output or multiplier analysis. The latter of which suffers from a number of critical shortcomings, identified on pages 296-97 of the Draft Report, when used in the way it has by DGR advocates.

APPEA understands that like most CGE models, Deloitte Access Economics' (DAE) model accounts for capital ownership based on a standard mix – pool – of foreign and domestic sources. It is also important to recognise that it is Gross National Income not Gross Domestic Product where the relationship between foreign investment and consumption plays out.

When conducting CGE modelling, a critical parameter is the long run elasticity of supply of labour which is assumed greater than zero in the DAE modelling. Under this scenario, given the investment and economic activity that is displaced following the introduction of the DGR policy, the modelling indicates that the labour market does not return to full activity hence the enduring employment impacts.

The assessment of the various modelling exercises by both the ERA and ACIL Allen Consulting identifies a lack of independent, WA-centric, economic modelling of the WA DGR policy impacts. The work, though, has identified the appropriate modelling approach (CGEM) and some of the input challenges, for a WA specific piece of work.

APPEA reiterates our *Discussion Paper* submission recommendation that the ERA conduct its own general equilibrium modelling to quantify the impacts of the WA DGR policy.

[3] See: www.businessnews.com.au/article/Alcoa-squeezes-contractors

[4] See: www.dsd.wa.gov.au/documents/Prospect_September_November_2013.pdf

Concluding Remarks

APPEA commends the ERA for the analysis undertaken on DGR. The oil and gas industry supports the recommendation for the removal of WA's DRG policy. APPEA calls on the Government to act immediately and remove this protectionist measure which is effectively leaving Western Australian households short changed.

APPEA welcomes the opportunity to discuss our submissions further with the ERA. Please contact Mr. Adam Welch, Senior Policy Adviser on

Yours sincerely

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