Mr L Rowe
Chair, Economic Regulation Authority
PO Box 8469,
Perth BC WA 6849.

Dear Mr Roe,

The DomGas Alliance represents that major industrial users of natural gas in Western Australia: companies, which provide thousands of jobs, help drive regional development and support local communities.

The Alliance provided a submission in response to the ERA's 2013 Discussion Paper and welcomes the opportunity to provide comment on the subsequent Draft Report released in April 2014.

In our previous submission we noted that through its 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."
>
> "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."[1]

Despite these reservations, the Alliance also noted that it would take the ERA's commitment to a "pragmatic" approach to these inquiries at face value.

It is therefore disappointing, that the ERA's draft report has again called for the domestic gas reservation policy to be rescinded.

Given the high importance and dependence the state has on natural gas, it is surprising how little analysis has been performed by the ERA in coming to its view. Instead, there has been a heavy reliance on a report commissioned by opponents of the policy, with no consideration to the broader economic benefit users of natural gas provide.

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[1] DomGas Alliance submission in response to the ERA Discussion paper on microeconomic reform in Western Australia, December 7, 2013

That the ERA would acknowledge the dangers of relying on a report that, in its own words, relies on "modeling exercises where the results are in line with the interests of the party funding the research"[2] only adds to the concerns about the ERA's approach to this issue.

This is further compounded by the ERA not identifying any real-world cases of the current policy having a detrimental impact on investment, production or export decisions in a Western Australian context. It also, fails to acknowledge that most countries that are energy rich have policies in place which puts the domestic use of energy ahead of energy exports.

The Alliance re-states the facts about the real world outcomes in Western Australia under a domestic gas reservation policy;

- investment in exploration for oil and gas has continued to grow to record levels;
- the LNG export industry, despite its protestations of the allegedly debilitating impacts of the policy, continues to post record levels of LNG exports; and
- investment in new projects last year alone stood at an estimated $116billion.

This reality should not be ignored.

The DomGas Alliance believes the lack of evidence to support the recommendation is best reflected in the immediate response from both the State government and Opposition in rejecting this draft recommendation.

The Alliance believes the government is correct to not accept such a recommendation when there has been no work done to understand the negative impacts and consequences for Western Australian industry and jobs and the State's economic development.

The Alliance provides the following additional comments for consideration.

- **"The costs that this policy imposes on the Western Australian economy far outweigh any benefits that it is believed to have." (Page 292)**

The draft report provides no evidence to support this claim.

In fact the report acknowledges that *"Quantifying the benefits of reform can be challenging – in many situations the ERA has not been able to source sufficient data or information to undertake a robust quantification"* [3]and that *"the ERA has not been able to quantify the benefits from the remaining recommendations."* [4]

The draft report further notes that *"the empirical evidence quantifying the net cost (benefit) to the economy as a whole is limited."* [5]

The ERA claims the costs of the policy "far outweigh" the benefits, again with no evidence or modeling to support this claim.

Without such modeling this conclusion is a statement of opinion, not fact.

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[2] ERA Draft Report on Microeconomic Reform in Western Australia, Page 295
[3] ERA Draft Report, Page 11
[4] ERA Draft Report, Page 12
[5] ERA Draft Report, Page 296

ACIL Allen, also warned that; "*The quantitative studies discussed in Section 4.2 (above) refer to the eastern Australian gas market, not to the WA market. …Conducting a new study focussing specifically on the WA economy and the WA gas market is beyond the scope of the current project."*[6]

ACIL Allen also noted that; *"In its absence, all that can be done is to infer broad orders of magnitude from the existing studies and to identify key differences between the WA situation and that pertaining in the eastern Australian market."*[7]

There is universal agreement amongst all participants in this policy debate that the West coast market is fundamentally different to the East coast market.

Given the heavy reliance of Western Australia on natural gas for its energy needs, the DomGas Alliance believes that policy debates and decisions should be based on something more than "broad inferences" drawn from studies primarily focused on the East coast market.

- **"The ERA acknowledges that choosing to end the reservation policy may involve some structural adjustments in the domestic market." (Page 14)**

It is not clear but we assume that "structural adjustments" means industry closures, job losses and loss of regional development opportunities. The report should attempt to quantify the number of jobs lost along with the economic opportunities lost.

The DomGas Alliance believes removal of the policy would have significant and serious implications for domestic industry in Western Australia.

The market for gas is already tight and the advent of floating LNG technology, which allows producers to circumvent any responsibility for providing gas into the domestic market, will only exacerbate the problem.

It is unfortunate that the ERA has done no WA-specific modelling of the impacts on industry and job numbers of its recommendation to rescind the policy.

- **"The ERA does not find any evidence of an on-going shortage of supply in the domestic gas market. A future gas supply shortfall is far from certain and is not an argument for government intervention." (Page 292)**

It is disappointing that in reaching this position the ERA did not consult with major gas users in the State or acknowledge that without gas reserved from LNG projects (Gorgon and Wheatstone) there would be a significant shortfall of gas post 2016.

The DomGas Alliance again refers to its initial submission that provides a users' perspective.

[6] DomGas Reservation Policy; Review of Literature and Policy Recommendations, ACIL Allen, March 2014, Page 29
[7] ACIL Allen, Page 29

The formal domestic gas reservation policy has been in place since 2006 but domestic commitment requirements have been a part of the policy and approvals landscape since the inception of the North West Shelf project in the 1980s.

If the ERA believes there is "no evidence of an on-going shortage of supply in the domestic gas market", it should also acknowledge the role the domestic gas reservation policy has played in ensuring this outcome.

In a recent interview the former Managing Director of Verve, Ms Shirley In't Veld, stated:

> *"When Verve was negotiating the gas supply agreement with Gorgon, (Chevron Australia Managing Director) Roy Kryzwosinki did say to me that if it were not for that policy, there is no way they would have put any gas into the domestic market. It would have all gone to LNG projects and that would have undoubtedly meant gas shortages for WA. I think experience has shown that (the policy) has worked in WA."*[8]

This statement also discredits the ERA's view that a future shortage is "far from certain". Without the policy in place, it is clear that existing LNG projects would not have directed gas to the domestic market. By any balanced viewing of the debate, this would ensure a supply shortage.

- **The draft report lists a number of "negative consequences" of the policy. (Page 292)**

"It increases reliance on subsidised gas prices, leading to over-consumption of the resources."

There is no evidence of over-consumption of gas in the WA domestic market and no analysis is provided by the ERA to support its claim. In fact a number of businesses who use gas in Western Australia are highly energy efficient by global standards, which suggests the resource is not being over-consumed. There is also no evidence the policy provides subsidised gas as gas is only made available if it is commercially viable to do so. Recent prices for gas in fact put Western Australian gas prices at some of the highest in the world.

> *"The policy artificially depresses domestic prices, which discourages domestic gas users to invest in technologies to lower or substitute their gas consumption."*

Given that coal is the most obvious alternative choice for power generation, it is surprising that the ERA makes no reference to the environmental costs or consequences of dramatically shifting the State's power generation from what is a relatively clean source of energy to one which has significant greenhouse emission implications.

These costs should not be ignored by the ERA. This again cast doubt on the ERA's unsubstantiated claim that the costs of the policy "far outweigh" the benefits.

> *"It perpetuates the existence of industries that may not have a comparative advantage in WA at the expense of investment in other industries."*

For more than three decades Western Australia has enjoyed the comparative advantage of having access to competitively priced natural gas.

[8] Former energy chief reflects on Verve challenges, Business News, 24 February 2014.

The ERA makes no attempt to identify what, if any, new enterprises would be attracted to the State to replace those industries which would leave due to removal of the domestic gas reservation policy and does not acknowledge the benefits of having a diversified economy able to withstand external influences such as fluctuations in the global price of a single commodity such as oil.

> *"It reduces the incentive for investors to invest in the gas industry in the longer term."*

In making this statement, the ERA ignores the reality of eight years of a formal domestic reservation policy in Western Australia.

Investment in oil and gas exploration in Western Australia has surged since the introduction of the policy. In 2013, the 7th full year of operation of the policy, WA recorded record investment in oil and gas exploration, record LNG exports and had an estimated $116billion of projects under construction. In addition, progress has been made in developing an unconventional gas industry in both the Canning and Perth Basins.

There has clearly been no diminishing of the attractiveness of investing in the industry in Western Australia.

- **"The Commonwealth of Australia has not adopted a domestic gas reservation policy for its offshore resources. It has argued that a national reservation policy would have a negative impact on investment and market development." (Page 296)**

Similar to the ERA, the Commonwealth's views are not based on any analysis and instead rely on a view that governments should not intervene in markets. This view may be acceptable if governments did not intervene across the entire market, however this is not the case. Governments instead intervene to allow joint selling arrangements (reducing competition), they intervene to control foreign ownership, they intervene to regulate assets, they intervene to allow oil and gas companies to warehouse gas reserves for LNG.

The ERA report, however, should point to the Western Australian experience, noted above. There is no evidence that the policy has had any negative impact on investment decisions in Western Australia. To the contrary, the figures confirm investment and export performance have shown remarkably strong growth since the introduction of the formal policy and now stand at record levels.

- **"The ERA notes that most Australian studies of DGR Policies are modelling exercises where the results are in line with the interests of the party funding the research. Additionally, all studies found by the ERA and discussed in this section take into account the effect on the entire Australian economy, rather than Western Australia alone.**

  "The empirical evidence quantifying the net cost (benefit) to the economy as a whole is limited. Two studies were commissioned by participants on the demand side of the market whereas the other two were commissioned by participants on the supply side. These studies represent different sides of the policy debate with each side having vested interests in whether or not the domestic gas reservation policy is adopted." (Page 296)

It seems contradictory that having noted the shortcomings of relying on reports funded by participants in the debate, that the ERA accepts the arguments put forward in a report commissioned by APPEA, the representative body of oil and gas producers.

The ERA has confirmed it has not tested the assumptions used in the modelling of that report.[9]

As noted above, the WA market is fundamentally different to the East coast market. This is also acknowledged by ACIL Allen.

- **"The ERA considers that the quantitative modeling available does not greatly add to the understanding of the effects of the DGR policy in Western Australia." (Page 297)**

This again seems contrary to how the ERA can justify its assumption that the costs of the policy "far outweighs" any benefit.

- **"Projecting future gas supply will be subject to considerable uncertainty due to the long timescale involved." (Page 303)**

The DomGas Alliance notes that this has not prevented the ERA from making a definitive statement that there is no on-going gas supply shortage and that a future shortage is "far from certain". The Alliance notes the ERA draft report is heavily caveated with qualifiers such as "far from certain" and "demand for gas *might not* be as high as implied". This again brings into question the definitive nature of the ERA's views on the effects of removing the policy.

- **"The ERA is of the view that export projects in Commonwealth waters do deliver a net benefit to the State, mainly in the investment phase. Consequently, the DGR Policy's net benefit is highly dependent on it not affecting the future investment in the LNG Industry. To the extent that DGR policy results in less export of gas, this would result in reduced investment." ….**

  "….However, the ERA is concerned that the DGR policy may have an unintentional adverse effect on the exploration for gas, both for the export and domestic markets. (Page 305)"

If the ERA remains concerned about of effect of the policy on exploration for gas it should address and acknowledge the actual outcomes in Western Australia. An impartial review of the outcomes delivered under the policy would quickly allay any such concern.

The formal policy has been in place in Western Australia since 2006 – a sufficient period of time for any potential adverse impacts to be identified.

In five of the seven full years of operation of this policy, Western Australia has posted new records for investment in exploration for oil and gas, only missing out on record investment levels in the two years following the global financial crisis. Since the GFC exploration investment levels have rebounded to post yet another record year in 2012 and 2013.

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[9] Email from ERA to DomGas Alliance, 29 April 2014

While the ERA and ACIL Allen make an argument that investment may have been even higher without the domestic gas reservation policy, given the peak investment that has occurred throughout this period and the pressure this has put on costs, it seems unlikely that further investment could have been sustained by the industry in any event.

In summary, if the ERA's position remains that the policy 'destroys investment', it should present some data to support this point of view.

The draft report makes numerous references to the selling of gas as being an international market. This is a reasonable statement. The draft report does not, however, acknowledge that the attraction of investment is also an international market. The ERA's concern about the impact of the reservation policy on investment decisions therefore should reference whether the policy puts Australia at a competitive disadvantage vis-à-vis other potential investment destinations. This would include whether there are similar policies – in structure, intent or outcome – in force in other investment destinations.

As the DomGas Alliance has previously publicly reported, Australia remains the only country where international oil companies can access and export gas without facing controls aimed at prioritising domestic supply. The ERA should acknowledge this market reality and provide evidence that Australia adopting a similar policy stance to other nations would make our nation a less attractive investment destination. If every other gas-producing nation has some form of restriction or policy intervention, it is difficult to sustain an argument that Western Australia having a similar policy intervention is a disincentive to investing here.

The statement that; "To the extent that DGR policy results in less export of gas, this would result in reduced investment" is not credible. There is no evidence that the policy has resulted in any projects being deferred or abandoned. All of the evidence points to the fact that the policy has allowed strong growth in exploration, production and LNG exports.

- **"In the short run, gas producers respond to this 'tax' by reducing total supply… This results in a contraction in the total supply of gas, including that reserved for domestic consumption, since one is proportional to another. Gas exports are also reduced." (Page 307)**

This is an example of where an attempt to interpret dry economic theory does not match the reality of real world outcomes. The statement is, in itself, not credible.

To suggest that a gas producer, having invested enormous capital in LNG production facilities, would then reduce the amount of gas they produce for export because they are concerned about having to supply gas to the domestic market ignores the reality which in fact sees more gas being exported than going into the domestic market. By 2020 Western Australia will export 6700 TJ/day of gas compared to the domestic market of approximately 1100 TJ/day.

- **"In the long run, however, domestic producers will respond to the lower return on gas production through their investment decisions. Less profitable gas production will lead to a reduction in investment in the industry and, as a result, total supply will fall even further. The recent experience in Western Australia stands as testament to this." (Page 308)**

It is uncertain which “recent experience” this statement is referring to.

The real world recent experience in Western Australia has seen new domestic gas production facilities come on-stream with the Devils Creek and Macedon projects. The existence of the domestic gas reservation policy did not prevent these investment decisions.

The ERA’s draft report regrettably does not consider or analyse the reverse of the argument. While the Deloittes argument is that higher domestic prices (linked to global prices) will attract new investment into projects (particularly on-shore projects) aimed at supplying the domestic market, it makes no reference to the effects of demand destruction. Higher domestic prices would inevitably destroy demand and this impact must be considered. In other words, removal of the domestic reservation policy may suit the off-shore based LNG exporters but would do nothing to encourage on-shore production for the domestic market.

This aspect of the debate would have been worthy of due consideration by the ERA.

- **“Over time, as the experience in Western Australia demonstrates, this raises the risk that long term domestic supply is in fact compromised by the DGR rather than assured by it.” (Page 308)**

After eight years of operation, there is no evidence that the domestic gas reservation policy has compromised domestic supply, in fact without it the domestic supply would be seriously reduced and WA could be experiencing shortfalls as early as 2016.

- **“The net losses are likely to be large and can be estimated by investigating the magnitude of projects rendered uneconomic through the scheme and the lost profits to producers.” (Page 309)**

In its final report the ERA should identify which Western Australian projects have been “rendered uneconomic” by the domestic gas reservation policy.

The reality is that there is no evidence that the reservation policy has led to the deferral or abandonment of a proposed development.

- **“The DGR Policy is unlikely to deliver more domestic gas into Western Australia, let alone be a net benefit to the State, if it contributes to future investment being lower than it would have been in the absence of the policy.” (Page 310)**

No justification is provided by the ERA for the first part of this statement. The evidence to date is that the policy has delivered gas into the domestic market that would otherwise have been directed to the export market (Gorgon and Wheatstone).

Western Australia is enjoying record investment in exploration, record LNG exports and had projects worth $116billion under construction in 2013.

If the ERA is of the view that the policy has hampered investment, it should identify which projects or investments have not proceeded and quantify the cost of that to the State.

- **“Since the DGR policy requires the infrastructure to be built immediately…” (Page 310)**

The Woodside Pluto project was given State agreement under the domestic gas reservation policy. The Pluto project commenced construction in 2008 and exported its first cargo of LNG in 2012. Despite coming under the domestic gas reservation policy, according to the Woodside website the project currently does not have a domestic gas train.

> "Onshore infrastructure comprises a single LNG processing train with a forecast production capacity of 4.3 million tonnes a year."[10]

- **"DomGas Alliance has argued that the DGR policy will not have a negative impact on future investment. As evidence, it has provided data which shows that total gas exploration in Western Australia has increased after the announcement of the Policy. The ERA is not convinced of this argument since the counterfactual of how much exploration would have occurred without the DGR Policy is not known. The data that the DomGas Alliance has presented includes exploration for both export and domestic fields. It is likely that the increase in gas exploration is due to high international oil and gas prices rather than the DGR policy. Indeed, exploration for gas specifically for the domestic market would likely have been higher had the DGR not been in place."**

This is a misrepresentation of the DomGas Alliance submission and should be corrected.

At no time has the DomGas Alliance argued that the increase in gas exploration is *due to* the domestic gas reservation policy. We have simply noted the fact that, contrary to the assertions of the upstream industry, the policy has in no way led to a flight of capital from Western Australian or a reduction in exploration investment.

Our original submission to the ERA simply states the fact that Western Australia continues to post new record levels of investment in exploration while at the same time setting new records for LNG exports.

The ERA provides no evidence to support its claim that exploration for gas specifically for the domestic market would have been higher had the DGR not been in place. If it has such evidence, it should be included in the report.

- **The DomGas Alliance points out that costs have increased in the LNG projects for reasons unrelated to the Policy and that the Policy has not been mentioned by project proponents who have cancelled projects. (Page 311)**

This again is a misrepresentation of the original DomGas Alliance submission which makes no reference to "cancelled projects".

The submission does note that the Ichthys project, which chose Darwin as its on-shore processing base, did so due to land access issues not domestic gas supply requirements.

This reinforces that the draft report was unable to identify any projects that have not proceeded because of the domestic gas reservation policy.

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[10] www.woodside.com.au

- **"NERA's report on gas restrictions in the US concludes that there is no case for intervention." (Page 311)**

The inclusion of the reference to the NERA report is disingenuous. The US situation is fundamentally different to that being faced by Western Australia. The US has a very deep, liquid market which is enjoying strong domestic supply brought about by increased investment in production. It is interesting to note this increased investment occurred in an environment where the US had restrictions on gas exports. Clearly these restrictions did not hinder investment. Additionally, the government provided highly favorable taxation regimes to incentivise the development of the unconventional gas industry, as well as directly participating in the development of the technology responsible for the advances which have led to vast quantities of natural gas being made available domestically in the US.

ACIL Allen sounded an additional note of caution about the NERA reporting;

> "However, like most of the Australian studies, it includes no details of the particular assumptions adopted in generating the results presented in the report."[11]

It is surprising that the ERA would give such prominence to a report based on the US market when it has not been possible to test the assumptions underpinning that report's findings.

The US comparison is completely irrelevant to the Western Australian situation. If, however, the ERA chooses to include this comparison in the final report, it should also include references to the national interest clauses considered as part of the LNG export approvals process in the US and the government's involvement to promote new sources of supply.

- **The ERA believes that the DGR policy should be rescinded as soon as practicable.**

The DomGas Alliance does not support this statement.

- **Other comments**

The ERA's draft report has ignored the issues raised in the ACIL Allen report in relation to capturing economic rents in the absence of a domestic reservation policy.

ACIL Allen noted that;

> "An important contribution to the debate on domestic gas reservation regimes was the Grattan Institute's point that economic arguments opposing gas reservation policies implicitly assumed that governments have in place tax/royalty regimes that capture a high proportion of resource rent (net imputed value of resources in situ). It explained: '.... the argument that Australians have more to gain from trading LNG than they have to lose from higher prices assumes that appropriate tax and transfer systems are in place'."[12]

The ERA draft report remains silent on this issue. If the ERA is advising the government to rescind the policy it is reasonable to assume the ERA also has a responsibility to advise the government and the broader community on whether the current taxation/royalty regime is adequate to "capture a high proportion of resource rent".

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[11] ACIL Allen, Page 22
[12] ACIL Allen, Page 23

As the ACIL Allen report notes,

> "Western Australia gains from Commonwealth spending in the state that is funded by the petroleum resource rent tax, but other states share that spending. The state government has limited ability to influence the share of revenue allocated to people and activities in Western Australia."[13]

The ERA's final report should acknowledge that while the Commonwealth may gain additional revenue from removal of the policy, there is little evidence to suggest an adequate share of this will flow back to Western Australia to compensate for the loss of industry, jobs and regional development.

The ACIL Allen report also makes several references to the removal of joint marketing arrangements, a move it notes would be *"solidly grounded in economic principles."*[14]

The ACIL Allen report concludes that;

> "If there is concern that ACCC's approval of joint marketing arrangements has provided producers with potential market power, this could be addressed by prohibiting such arrangements."[15]

As joint marketing is one of the factors that is distorting the Western Australian market, it is surprising that the ERA draft report remains silent on this issue.

Further information.

The DomGas Alliance would be happy to provide further information or to discuss any details of the above submission with the ERA if it would assist in developing a more considered final report.

Yours sincerely

MATT BROWN
Executive Director

[13] ACIL Allen, Page 32
[14] ACIL Allen, Page 3
[15] ACIL Allen, Page 31