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25 June 2010

Economics and Industry Standing Committee
Legislative Assembly Committee Office
Level 1
11 Harvest Terrace
West Perth WA 6005

by email: laeisc@parliament.wa.gov.au

RE: SUBMISSION TO THE ECONOMICS AND INDUSTRY STANDING COMMITTEE REGARDING PARLIAMENTARY INQUIRY - DOMESTIC GAS PRICES

Dear Sir/Madam,

Synergy is pleased to provide this submission to the Economics and Industry Standing Committee concerning the Parliamentary Inquiry into domestic gas prices in Western Australia.

If you have any questions concerning the submission please do not hesitate to contact myself on 6212 1076 or email simon.adams@synergy.net.au. Alternatively, please contact Catherine Rousch on 6212 1125 or email catherine.rousch@synergy.net.au.

Regards,

Simon Adams
Senior Legal Counsel
Synergy

Submission

to the

Economics and Industry Standing Committee

regarding

Parliamentary Inquiry - Domestic Gas Prices

25 June 2010

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1 Background

Synergy is pleased to provide comment to the Economics and Industry Standing Committee (**Committee**), entrusted in April 2010 by the Parliament of Western Australia to examine the issue of domestic gas (**domgas**) prices for industry and consumers in Western Australia (**WA**).

WA is the most gas-reliant economy in Australia, with natural gas supplying more than half of the state's primary energy requirements and fuelling at least 60 percent of the state's electricity generation. Since entering the retail gas market in 2003, Synergy has become the second largest gas retailer in WA. Synergy purchases gas from the Carnarvon and Perth basins and delivers gas to customers consuming 180 GJ of gas or more a year in the area bounded by the south west interconnected electricity system (SWIS) which extends to Geraldton in the north, Kalgoorlie in the east and Esperance in the south east and includes the Perth metropolitan area.

Synergy would like to provide comment on each of the terms of reference that the Committee is required to investigate.

2 Price of gas for customers in Western Australia

2.1 Retailer Pricing

Successful gas retailers employ a pricing approach which will ensure that they can compete for gas customers at prices that will maximise the net returns to their business. A range of factors are taken into account, including:

- Wholesale gas procurement costs;
- Current and future wholesale contract positions, including contract length and price;
- Current availability of gas, including quantities and price;
- Future outlook for demand and supply;
- Transportation costs;
- Risks associated with the procurement of gas e.g. take-or-pay transport and gas supply exposures;
- Prices and terms and conditions being offered to gas consumers by competitors;
- For customers, their individual risk profile, contract terms - wholesale cost drivers for shorter term contracts are very different to those applying to longer term contracts – and the perceived value of the gas.

In its final report concerning the delivered price of natural gas to tariff customers in New South Wales (**NSW**) [1], the Independent Pricing and Regulatory Tribunal (**IPART**) estimated that the following costs are incurred in providing a retail gas service:

- Field price of gas and cost of haulage - 30 percent;
- Distribution and metering costs – 60 percent;
- Retailing costs, including billing, marketing and net profit margin – 10 percent.

[1] Final Report: *Review of the Delivered Price of Natural Gas to Tariff Customers Served from the AGL Gas Network in New South Wales*, February 2001, Appendix 2, p. 29.

By comparison, Synergy, one of WA's most successful energy retailers, estimates its breakdown of gas costs to be:

- Field price of gas - 65 percent;
- Transportation and reservation - 20 percent;
- Distribution and metering costs – 10 percent;
- Retailing costs, including billing, marketing and net profit margin – 5 percent.

That is, in WA, the commodity cost of gas makes up a far higher percentage of the total retail cost of gas than in NSW. However, over the last 12 months the commodity price has softened marginally due to the global financial crisis.

2.2 Market maturity

In recent years, the domgas market in WA has undergone significant reform. Significantly:

- There is no longer a single, vertically integrated, state-owned, buyer of gas (SECWA);
- There are now over 30 customers that purchase gas directly from producers;
- There is an increase in the number of retailers registered to sell gas to consumers, including Synergy, Alinta, Perth Energy and Wesfarmers;
- There are a number of brokers providing gas trading services;
- There has been a significant increase in domgas demand, from 250 PJ in 1999-00 to 350 PJ in 2007-08[2];
- Additional transportation and storage options, such as the Mondara storage facility at the northern end of the Parmelia Pipeline and the under and over services on the Dampier to Bunbury Natural Gas Pipeline, are now available;
- There is greater connectivity between pipelines, encouraging both physical and commercial gas trades;
- Short-term and long-term trading in secondary markets is common, despite no official market to implement such trades; and
- The Gas Quality Specifications have recently been broadened, allowing producers to supply leaner quality gas.

These advancements have made a significant contribution to the development of the market and there is now a significant, competitive retail gas market in WA with numerous players.

So why does the price of domgas remain so high for consumers? Synergy believes this is predominantly due to the market power of producers, exercised through joint marketing and through the retention lease renewal process.

2.3 Market Power

Currently, two gas suppliers - the North West Shelf (**NWS**) Project joint venture and the Varanus Island joint venture - account for approximately 99 percent of the WA domgas market. With these producers holding significant market power and an ability to control the level of supply in the market, no incentives exist for them to compete effectively. Knowing that demand already outstrips supply and with an economy anticipating a strong return following the global financial crisis, suppliers simply refuse to sell unless they achieve the prices and terms and conditions determined predominantly at their absolute discretion. In the absence of market forces, purchasers have no alternative other than to accept these if they wish to stay in business or commence a new venture.

[2] *Western Australian Mineral and Petroleum Statistics Digest 2008-09*, Government of Western Australia, Department of Mines and Petroleum, Table 5, p. 56-57.

Through involvement in various joint venture projects, these same large producers enjoy the benefits of complete transparency with regard to pricing and terms and conditions across the industry. Competition is therefore reduced and the cost of gas to domestic consumers is ultimately increased.

Joint marketing

Gas consumers are currently prevented, other than in limited circumstances, from jointly purchasing gas, and therefore miss out on benefits such as lower prices.

In its determination in respect of the application by the Gorgon Gas Project joint venture participants to jointly market and sell natural gas, the Australian Competition and Consumer Commission (**ACCC**), despite approving the request, noted that it would expect that separate marketing would result in a more competitive market than would be the case under joint marketing[3]. Additionally, the ACCC acknowledged that if gas producers were to separately market their gas, the development of the WA domgas market could be assisted in the medium to long term by providing more market opportunities for the entry of gas storage providers and aggregators[4].

Earlier this month, WA Government Departments, in discussions with the ACCC regarding the application by NWS Project joint venture partners to continue the joint marketing of domgas, made the point that, given the current significant demand for domgas, NWS producers “would have no trouble finding buyers if they were marketing separately”[5]. The ACCC is still to make its determination on this matter.

Retention leases

The existing retention lease approvals process creates significant barriers to entry for new players and protects larger incumbent producers. The current closed nature of the process contrasts sharply with the procedure employed for environmental approvals, which requires public disclose of detailed information, much of which could be described as commercially sensitive.

More transparent processes, including a publically available list of assumptions associated with the costs of development and potential revenue streams, would ensure that domgas prices are fully justified.

3 Price comparison with other states

Currently, WA domgas customers pay substantially more than consumers in other states despite there being substantially greater volume of gas reserves in WA. Commodity gas costs in WA for new supply can be as high as $9 per GJ.

The critical gas supply shortages following the shut down of Varanus Island on 3 June 2008 created opportunities for substantial profit taking by gas suppliers and there is anecdotal evidence of some suppliers selling at or near the cost of diesel (around $30 per GJ).

In its recently released draft report concerning the review of regulated gas retail tariffs and charges for standard retailers in NSW for the 2010-13 regulatory period, IPART determined the prudent and efficient level of a retailer’s wholesale gas costs to range from $6.17 per GJ to $7.31 per GJ ($2009/10)[6]. Wholesale gas costs were determined to be comprised of[7]:

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[3] *Determination - Applications for authorisation - in respect of the joint marketing and sale of natural gas from the Gorgon Gas Project for supply in Western Australia*, 5 November 2009, par. 7.176, p. 60.

[4] Ibid, par. 7.215, p. 68.

[5] NWS Project applications for authorisation A91220-A91223, Government of Western Australia (WA) Departments - record of meeting, 1 June 2010.

[6] *Review of regulated retail tariffs and charges for gas 2010-2013*, Draft Report, Independent Pricing and Regulatory Tribunal, April 2010, p.27

- Commodity gas costs - it is prudent and efficient for a retailer to have a portfolio of supply;
- Additional deliverability costs e.g. extra supply to meet peak demand that is not already catered for under commodity gas contracts;
- Transmission costs; and
- Additional costs e.g. market fees and extra costs associated with the new Short Term Trading Market.

Whilst a breakdown of these costs has not been made public, comparison has been made by IPART with publicly available wholesale gas cost benchmarks released by the Queensland Competition Authority (**QCA**) and by the Essential Services Commission of South Australia (**ESCOSA**) for Queensland and South Australia (**SA**) respectively[8].

In Queensland, the wholesale gas cost ($2009/10) was determined to be $5.82 per GJ (2008/09) to $8.22 per GJ (2012/13) with a base (commodity) gas supply cost of $4.08 per GJ (2008/09) to $6.13 per GJ (2012/13). In SA, the base gas cost ($2009/10) for 2010/11 was determined to be about $3.96 per GJ.

Despite the substantial gas reserves and existing infrastructure already in place in WA, the base cost of gas for new supply exceeds not only that in NSW, Queensland and SA, but exceeds the total wholesale cost of gas in each of those states, as determined to be prudent and efficient by independent industry regulators.

4 Price comparison with international LNG

The Australian liquefied natural gas (**LNG**) export market has gradually expanded since the first shipments from the NWS in 1989. Eventual export is expected to quadruple to over 50 million tonnes of LNG per year[9] with the further expansion of the NWS and a number of other WA projects including Gorgon, Browse and Wheatstone.

The upward trend in domgas prices in WA is caused by the uncertainty about future gas field development costs in light of significant overall cost increases, and by the better prices currently being achieved for LNG exports.

In 2006, the incumbent WA Government released its policy on securing gas supplies[10]. It committed to negotiate with proponents of export gas (LNG) projects to include a domestic gas supply commitment as a condition of access to land in WA for the location of processing facilities. The State’s objective was to secure domgas commitments up to the equivalent of 15 percent of LNG production from each export gas project. This target reflected estimates of future domestic gas needs, estimated gas reserves and forecast LNG production and was to be subject to periodic review. Producers would be given maximum flexibility regarding how their domgas commitments were fulfilled e.g. from a different source.

In May 2008, Apache flagged big rises for WA domgas prices, indicating that it was seeking significant price increases from spot gas sales and shorter term contracts in the five year range[11]. Not long after, in January 2009, Apache and its partner Santos signed a deal with Citic Pacific to supply gas from the Reindeer field at US$7.80 per GJ, linking the price of gas

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[7] *Gas Retail Price Review – Wholesale Gas Costs*, Public Version of Draft Report to Independent Pricing and Regulatory Tribunal of NSW, McLennan Magasanik Associates, April 2010.

[8] *Review of regulated retail tariffs and charges for gas 2010-2013*, Draft Report, Independent Pricing and Regulatory Tribunal, April 2010, p.29, Tables 3.2 & 3.3.

[9] *Australia’s natural gas – issues and trends*, Research Paper no 25 2007-08, Parliament of Australia, Parliamentary Library, April 2008

[10] *WA Government Policy on Securing Domestic Gas Supplies*, Department of the Premier and Cabinet, Government of Western Australia, October 2006.

[11] *Apache to Increase WA Domestic Gas prices, Start Halyard 2010*, Dow Jones, May 5 2008.

to international oil prices of US$50 a barrel[12], the second Australian gas contract to do so. A few months earlier, in October 2008, Santos had reportedly signed a deal with Moly Mines for US$11.50 per GJ, linked to oil at US$90 a barrel[13]. In commenting on its Reindeer deal, Citic Pacific stated that "commercial gas supplies were at critical levels in Western Australia"[14].

Synergy is currently finding it difficult to acquire sufficient tranches of gas from the Carnarvon Basin at sustainable prices to enable it to supply its current customer base well into the future. It is now critical for an increased commitment of gas reserves to the domestic market to ensure sufficient supply to meet not just current demand requirements but also additional growth as WA bounces back from the global financial crisis and existing reserves deplete.

LNG netback price

The most commonly used basis for comparing export LNG and domestic gas prices is the LNG netback price. This is defined as the LNG delivered price less the costs of transportation, liquefaction and shipping i.e. it is the value of the exports at the wellhead. Consultant MMA, in its report to the Queensland Government concerning the viability of that state's LNG industry[15], noted that, from a gas producer's perspective, in deciding between investment in an LNG project and investment to support domestic supply, the relevant comparison would be the project returns on investment or the internal rate of return (**IRR**). LNG and domestic projects with the same IRRs should be equally attractive since they would generate equivalent returns on shareholder capital. MMA concluded, however, that the correct measure for upstream returns is the return from the LNG project **as a whole**.

For the Roma coal seam gas project, MMA calculated an LNG netback price of $10.83 per GJ at oil prices US$80 per barrel, with a rate of return for the producer of over 40 percent but a return to the project as a whole of 24.7 percent. The equivalent return price, that is the domestic price necessary to produce an LNG project equivalent return, was estimated to be $4.23 per GJ, substantially lower than the LNG netback price.

5 Price reduction measures

There are a number of measures that Synergy believes could be employed to reduce the price of domgas to the WA market. These are outline below.

5.1 Separate marketing

The WA domgas market is expected to continue to experience a tight demand/supply balance and there appears to be no relief, with demand likely to remain high and indeed increase for the foreseeable future as new customers seek substantial supply. The supply position appears unable to keep pace, with new sources barely sufficient to replace existing supplies as reserves deplete.

Synergy considers that each partner in the large offshore WA joint venture projects is a highly skilled and profitable multinational company that would have the commercial acumen required to successfully negotiate individual sales contracts with domgas purchasers such as Synergy.

Synergy considers that a transition to separate marketing should be considered. In its recent submission to the ACCC regarding the application by the NWS Project joint venture partners to continue the joint marketing of domgas, Synergy stated that the incremental gas for which the applicants were seeking authorisation - some 100 TJ/d for 6 years out of an already

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[12] *Gas Supply Agreement for Australian Mining Operations*, www.citicpacific.com, 6 January 2009.

[13] *State gas prices to surge on Citic deal*, The Australian, 8 January 2009.

[14] *Citic Pacific Mining underwrites new gas development,* media release, Citic Pacific Mining, 6 January 2009.

[15] Final Report to Queensland Department of Infrastructure and Planning, *Queensland LNG Industry Viability and Economic Impact Study*, McLennan Magasanik Associates (MMA), 1 May 2009

operating production facility - would provide the perfect opportunity to initiate separate marketing obligations in WA[16].

5.2 Improving the retention lease process

As noted earlier, the existing retention lease approvals process creates significant barriers to entry for new players and protects larger incumbent producers. Synergy considers that more transparent processes are required, and promotes:

- A public, on-line, registry of State and Commonwealth retention leases that provides the cost assumptions, such as underwriting, of each project, as well as a clear indication on the current status of a particular application;
- Public disclosure of the parameters and assumptions used by the designated authority to test project commerciality;
- Publication of expert reports commissioned by the designated authority;

A review period, allowing third parties to submit information in relation to the assessment parameters to reinforce, or to challenge, the designated authority's draft decision.

5.3 Striking the right balance between LNG export and domestic supply

Ensuring the right balance between the LNG export industry and the long term energy needs of the local community will ensure downward pressure on the commodity price of domgas, whilst giving investment certainty to LNG proponents.

As such, Synergy supports recent recommendations by the DomGas Alliance concerning domgas reservations[17], including:

- Domgas reservation policy should be made an express condition in the granting and renewal of all gas exploration permits, retention leases and production licences;
- Domgas obligations should be unconditional and not subject to commerciality escape clauses;
- Policy should be consistently applied to discourage individual projects from claiming special exemptions;
- Obligation should be to <u>supply</u> domgas, as opposed to marketing/making available/offering to sell;
- In the event of any resources shortfall in a project or field, domgas supply should be accorded priority over LNG export;
- Specific leases should be set aside and granted only on the condition of exclusive domgas development;
- Producers should be given sufficient flexibility, but should be encouraged to adopt the most efficient means of meeting domestic supply obligations;
- Domestic supply commitment should expand with any future growth in gas reserves, production or LNG exports – that is, supply obligations should be applied as a percentage of reserves and production, as opposed to a fixed volume;
- Producers should be required to supply domgas prior to, or at least no later than, start-up of LNG production.

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[16] Letter from Synergy to ACCC re: North West Shelf Joint Venture Partners' Applications for Authorisation A91220-A91223, 30 April 2010

[17] *WA Domestic Gas Reservation: Giving the policy teeth*, DomGas Alliance, Dec 2009

5.4 Promoting domestic gas exploration

During economic downturn, inshore and onshore exploration activities, which are the most likely sources of competitive domgas supply, are impacted to a far greater extent than deepwater offshore exploration. This is because these projects are reliant on regular injections of risk capital from the local market.

The right incentives could promote smaller domgas developments or LNG projects with a domgas component. This would help balance the oil and gas industry's current focus on LNG exports and the incentives under existing tax and royalty arrangements to develop large scale LNG projects. Incentives could also encourage new frontier technical challenges such as onshore "tight gas" fields.

Synergy therefore encourages consideration of:

- Commonwealth and/or state grants to support new domgas developments;
- State royalty concessions for domgas developments;
- Increased federal tax deductibility for pre-wellhead expenses incurred by domestic gas developments; and
- Flow-through share schemes for domgas exploration and development.

5.5 Improving information transparency

Improving information transparency and symmetry across the gas supply chain would facilitate trading and ensure a more competitive market. Synergy supports recommendations made last year to the WA Government by the Gas Supply and Emergency Management Committee that would see[18]:

- Establishment of a permanent Gas Bulletin Board to improve information transparency to facilitate trading of standard transport and commodity contracts;
- Implementation of a Gas Statement of Opportunities to provide long-term gas supply and demand forecasts to facilitate a competitive market, efficient investment and inform Government policy development; and
- Consideration of a Short Term Trading Market to further facilitate the trading of gas contracts.

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[18] *Gas Supply and Emergency Management Committee - Report to Government*, Government of Western Australia, Office of Energy, September 2009.