ECONOMICS AND INDUSTRY
STANDING COMMITTEE

INQUIRY INTO DOMESTIC GAS PRICES

TRANSCRIPT OF EVIDENCE
TAKEN AT PERTH
MONDAY, 18 OCTOBER 2010

SESSION ONE

Members

Dr M.D. Nahan (Chairman)
Mr W.J. Johnston (Deputy Chairman)
Mr M.P. Murray
Mrs L.M. Harvey
Mr J.E. McGrath

Hearing commenced at 12.28 pm

GALLAGHER, MR KEVIN THOMAS
CEO, North West Shelf, Woodside Energy Ltd, examined:

COETZER, MR WILLIAM BENJAMIN
General Manager, North West Shelf Gas Pty Ltd, examined:

The CHAIRMAN: Thank you very much for coming today. We will just get stuck into it. We have a large gallery. This will be in two parts, first public and then we will go in camera.

The Witnesses: Yes. Thank you.

The CHAIRMAN: Thank you for your appearance today. This committee hearing is a proceeding of the Parliament and warrants the same respect that proceedings in the house itself demand. Even though you are not required to give evidence under oath, any deliberate misleading of the committee may be regarded as a contempt of Parliament.

In the lead-up to today's hearing you have indicated to the secretariat that you will request restrictions to some of the questions that may be posed by the committee. In accordance with this request, we will close the latter part of the hearing to the public to discuss these questions and the manner in which you may feel comfortable answering them. For now, there are a number of procedural questions I need answers to. Have you completed the "Details of Witnesses" form?

The Witnesses: Yes.

The CHAIRMAN: Did you understand the notes at the bottom of that form?

The Witnesses: Yes.

The CHAIRMAN: Did you receive and read the information for witnesses briefing sheet regarding giving evidence before a parliamentary committee?

The Witnesses: Yes.

The CHAIRMAN: Do you have any questions relating to your appearance before the committee today?

The Witnesses: No.

The CHAIRMAN: The committee has received your original and supplementary submissions. Thanks for your contribution. Do you wish to propose any amendments to your submission?

The Witnesses: No.

The CHAIRMAN: Before we ask questions, do you wish to make an opening statement or are there any additions to your submissions?

Mr Gallagher: Yes, I do.

The CHAIRMAN: Please go ahead.

Mr Gallagher: Thank you, Mr Chairman—committee. As I said, my name is Kevin Gallagher and I am the Chief Executive Officer of the North West Shelf venture. I am here today to represent the North West Shelf project participants and I am accompanied by Ben Coetzer, general manger of North West Shelf Gas, the marketing entity of the North West Shelf domestic gas sellers. I would like to state up-front that we welcome this inquiry as we believe it will provide greater transparency around bringing new gas supply to the market and the link between market conditions and gas prices. It is our hope that this will then bring balance to the public debate on gas supply.

The North West Shelf project is a major employer in Western Australia with over 1 500 people working in and supporting our operations. To construct the North West Shelf project today would cost more than $50 billion. As reported by Acil Tasman recently, over the period from 1989 to 2009, our LNG operation has generated export revenues of $60 billion and total annual taxation for the commonwealth and state of around $5 billion. We have also generated increased gross state product of more than $90 billion during this period. In the public debate on domestic gas prices a lot of blame has been laid at the feet of the gas producers. We challenge these claims, particularly those made by the Domgas Alliance, an organisation which represents many large companies who sell commodities at international prices.

Mr Chairman, let me assure you we understand the need to deliver on shareholder expectations, as the participants of the North West Shelf project are all successful companies in their own right. However, under the cover of speaking up for mums and dads, these industrial gas users continue to argue for susidised gas prices to benefit their bottom line. Interestingly, it rarely features in the public debate that even when applying the price assumptions of the Domgas Alliance, the wholesale gas price represents less than 25 per cent of a household gas bill, nor is it emphasised that the North West Shelf project does not sell gas in Western Australia's retail market or set the price of gas for residential consumers. Contrary to claims made by the Domgas Alliance, an increase in gas prices is not an indication of market failure, but, rather, of the market working effectively. Prices set as a result of increased demand have stimulated new development and have made new supply projects commercially viable. This is good for the state, improving diversity and security of gas supply. The truth is that Western Australia has an abundance of natural gas—known resources are around 130 trillion cubic feet, and new discoveries continue to be made. To put that into perspective, 1 tcf is enough to power a city of a million people for over 20 years. But if you believe some of the rhetoric, WA is facing a gas supply crisis, because exporting LNG comes at a cost to the local market. This is simply not true. LNG exports in WA have increased domestic gas supply and diversity. Importantly, domestic gas and LNG are different products; to compare the two is not an apples-with-apples comparison. Although the two products come from an integrated facility, they are subject to different production processes, and have a different composition, different transportation logics and a different market.

Mr Chairman and committee members, we seek, through your final report, a more balanced public debate on these issues. Price is just one of a series of terms and conditions reflecting value for product and market conditions at any particular point in time. It is a matter of fact that recent sales of domestic gas have delivered higher prices than those struck seven to 20-plus years ago at a time when oil was selling for less than $20 a barrel. Our lowest LNG price was agreed during a time when the oil price was low and the market reflected power in the hands of international buyers.

The real issue facing Western Australia is not a lack of gas, but the remoteness and difficulty of developing it commercially. New gas supply is available in WA; the proviso is that the demand is genuine—I stress "genuine"—and that the buyers commit to contracts to enable the gas to be economically supplied and competitive against its alternatives. We are particularly concerned about the ill-informed views framing the public discussion about future domestic gas supply from the North West Shelf. While we have legacy contracts to 2020, we continue to market gas to new and existing customers in WA. I can advise the committee, consistent with our ongoing marketing practices, we are actively engaging with customers for new supply. We have made significant investment in our domgas infrastructure and continue to maintain the facilities to ensure that capacity is available for ongoing competitive marketing. Ultimately, future supply will be contingent on genuine demand and market conditions.

In conclusion, we acknowledge that the supply of domestic gas from the North West Shelf project was facilitated by a visionary state government that provided infrastructure which has done much to develop our state and deliver reliable, safe and competitively priced gas supply for more than two decades, we are proud of our contribution to Western Australia's gas market over the past 26 years and that we have met and exceeded our domestic gas supply obligations. The focus of our investment today is on exploration and offshore infrastructure intended to secure gas flows from depleting and smaller undeveloped fields to maximise the life of the North West Shelf project. To this end, we have recently invested more than $6 billion in infrastructure development.

The WA gas market is broadly characterised by two major pipelines, two major suppliers and five significant customers. There is limited transportation, negligible storage, few brokers or aggregators, no gas-related financial market and a very limited secondary market. For these reasons, the Western Australian gas market is not the same as Victoria, nor any other market in Australia or overseas. It is a simple truth that recent domestic gas prices are higher than those struck some time ago and under very different circumstances, but another simple truth follows: as a result of recent prices, we are now seeing an unprecedented supply response. This is evidence that the market is working.

We trust that our comments today will assist the committee to make recommendations that reflect the uniqueness of the WA gas market and that acknowledge the role that long-term low gas prices have delivered to the state. The participants of the North West Shelf project believe that the most significant benefit to Western Australian gas consumers will come from an informed and balanced public debate in which the value of the market being allowed to work effectively is fully understood.

As we have seen, market mechanisms are the best encouragement for investment in gas projects and will support long-term growth of a competitive, transparent and diversified energy market, and that will be to the benefit of all Western Australians. Thank you Mr Chairman.

The CHAIRMAN: Thanks very much, Mr Gallagher.

Just to clarify, North West Shelf, the firm that you represent, is the manager of the North West Shelf Joint Venture, is it not?

Mr Gallagher: That is correct.

The CHAIRMAN: I have some introductory issues. North West Shelf has been and still is the major supplier to gas. What proportion of the total domestic gas market do you supply?

Mr Gallagher: I will hand that question over to Ben, if I can, to give a more specific answer.

Mr Coetzer: At the moment, North West Shelf Gas provides about 60 per cent of the state's domestic gas.

The CHAIRMAN: How many contracts do you have? Is it a large number, or what is the contract-type structure? We will not go into details of the contracts—just generally.

Mr Coetzer: I could not you give you an exact number, but certainly a double digit number of contracts.

The CHAIRMAN: Okay, good. And all that gas comes from the North West Shelf?

Mr Coetzer: That is correct.

The CHAIRMAN: And your joint venture composition?

Mr Gallagher: There are seven joint venture partners. If you want me to go through those, I can. Woodside Energy is the operator of the facilities. There is BHP Billiton, BP Development, Chevron, CNOOC, MIMI and Shell.

The CHAIRMAN: Okay. So CNOOC is the new one?

Mr Gallagher: That is correct.

The CHAIRMAN: That came on when you signed the contract with China?

Mr Gallagher: That is correct

The CHAIRMAN: As you quite rightly and comprehensively indicated in your statements, the origin of this inquiry is there is a widely held perception in the public that gas prices are not only rising sharply, but also there is a threat to supply. Nonetheless, there is concern about supply and a rise in price. That is the origin of this, and it will percolate down. Western Australia is highly dependent on gas, not only for direct consumption—household is not huge but industries—and, of course, electricity. we are one of the highest users of gas and electricity in the world. What is your view? Do we have growing crisis and, if so, how is that going to be resolved? There are a lot of uncertainties, and no-one knows the future for sure, but could you give us a story of your perception? Do we have one; and, if not, how is it being resolved?

Mr Gallagher: Good question to start the day with. I think the best way to respond to that question would be to start by saying that, first of all, I do not believe the major issue facing Western Australia is gas supply. In my view, it is more a case of the remoteness of the resource and the complexity and difficulty of developing those resources commercially. I see LNG as an enabler for the market, as opposed to a threat. Quite frankly, the signals the market is sending us today are that the market is working. I have heard that higher gas prices are seen by some—as you indicated—as the market failing. I disagree with that. Quite frankly, I think the response we are seeing from the market is a sign that the market is working, with progress on major other gas projects such as Reindeer, Macedon and Gorgon, taking us to a place over the next five years; that is opposed to having a market with only two major suppliers, we will be moving to a market with five major suppliers. So not only will that be new supply coming to the market, but it will also be a greater diversity of supply, and that can only be good for the development of the WA gas market. Yes, I think the market is working. I refute the allegations that we are going to run out of gas, and I think the signals from the market are that new projects are coming on stream.

Mr W.J. JOHNSTON: On that very topic of “we are not going run out of gas” and I think the terminology is “reserved production ratio for the joint venture”, how long do you have in reserve for your current production levels?

Mr Gallagher: Ben, do you want to try and address that question?

Mr Coetzer: It is a good question and there are a number of different facets to the answer I guess, so I will try and cover a couple. Firstly, one of the issues that we have as a joint venture is that the venture does not necessarily report its own reserves. Each of the independent companies that are part of the venture own different proportions of those reserves and therefore report their own reserves. They also sell different proportions of the product in different joint ventures. It is not a simple subtraction and division-type exercise. That said, because natural resources like gas tend to deplete, you get to a point where you can no longer maintain full capacity and you get into a depleting and therefore reducing production rate. So the reserves-to-production ratio is dynamic and changes with time, not just with the depletion of the resource but also because both the numerator and the denominator change in a complex fashion. That is it. Possibly the best way to respond to that is to say that we anticipate being able to maintain our full production rate for at least a decade.

[12.45 pm]

Mr J.E. McGRATH: Further to that, Mr Gallagher, you mentioned the amount of gas that Western Australia has for the future. Was your figure all offshore gas or did that include onshore gas? For how many years, do you see, there will be enough offshore gas out there to meet the LNG needs and also the domestic market?

Mr Gallagher: The figure I quoted I believe refers to the estimate of reserves in the Carnarvon Basin, which is predominantly offshore if not totally offshore. As for the needs to meet LNG demands, certainly to meet our contractual commitments, yes, we have enough reserves to meet our contractual commitments. I am not sure I understand the question beyond the scope of our North West Shelf venture contractual commitments.

Mr J.E. McGRATH: Just further, you were talking about meeting the needs of the state, I guess, and you mentioned a figure, so many trillion—I cannot recall the figure, but it indicated there was a massive amount of gas out there and we are never going to run out and it is a bit of a misinformation going out that we are going to have a problem with supply. I guess I was asking you to elaborate on that: Where is it coming from? Where are your estimates coming from? Are they just in the Carnarvon Basin? Are they in other basins or do they include onshore possibilities?

Mr Gallagher: Thank you for clarifying that. Obviously, I am here to talk about the picture as far as the North West Shelf venture is concerned and our impact on that future. Currently we have supply commitments in place that both meet and exceed the obligations as per the state agreement with regards to the North West Shelf project. That state agreement required us to commit, I think, 5 064 petajoules of gas to the domestic gas market. As I said, I am pleased to say that we have not only met but exceeded that with our current obligations and we expect to pass that point of 5 064 petajoules in 2014. We currently have contracts, however, in place committing supply to the Western Australian domestic gas market beyond the end of this decade. As I said in my opening statement, we also are still actively marketing gas in the Western Australian gas market for periods beyond 2014.

The CHAIRMAN: You have been a legacy supplier of gas in the state for 25 years and you have made a big contribution. On your agreement with the state you have an agreement to provide 5 000-plus and that runs out in 2014. That is what you have just said. You also have some contracts to 2020. The year 2014 is a decision point and then whenever those other contracts—between 2014 and 2020, what is the amount of gas you have contracted?

Mr Gallagher: First of all, we do not see it as a decision point. Effectively, for us that is when we will have supplied the volume that meets the requirements of —

The CHAIRMAN: That is what I mean. You become ex contract in terms of your aggregate supply in your agreement. You exit your agreement, kind of.

Mr Gallagher: Well I can hand to Ben to try to bring a bit more clarification to what that actually means.

Mr Coetzer: It is a very useful thing to have this conversation because that is not the correct interpretation. Our obligations to supply are contractual. The 5 064 petajoules is under the state agreement and we very much see that as a lower limit, not an upper limit. There is no intent and there is no capacity to cut off supply once we hit that level. We are contractually obliged to continue supplying gas beyond that point and we will continue to do so.

The CHAIRMAN: From 2014 you have some legacy contracts—as you have called them—to 2020. What volume of gas are those?

Mr Coetzer: We would have to take that on notice. There is a fairly detailed calculation to be done.

The CHAIRMAN: Okay. The Department of Mines and Petroleum put out a forecast; have you seen that?

Mr Coetzer: Yes.

The CHAIRMAN: It is kind of a scenario-based forecast—forget the demand side, but the supply side. It makes assumptions about North West Shelf domestic gas supplies from 2014 and there are some real shock drops. Do you have any comments on that forecast? It has been widely used and referred to.

Mr Coetzer: Yes, I believe it served a useful purpose, when it originally appeared, to generate the discussion that we are currently having. One of the things to note that is really important to note when interpreting that graph is that it is firstly plotting prospective demand, which, as Kevin said, is different from real demand from customers out there currently looking for gas, and comparing it with contracted gas. In any market there is always a significant gap between the contracts in place today and the gas that people might want tomorrow. That is essentially the space that the marketing occurs in; that is where we go out and form new contracts, so you would expect to see that.

As far as the specifics of that graph go, there are several demand lines reflecting different average growth scenarios in the state over, as I think the DMP folk might have mentioned earlier, there is a hockey stick component to them that adds up what they consider to be a prospective short-term projects. To me that fundamentally undermines the credibility of those demand scenarios, because not all of those potential customers will take gas and that is not reflected in that step up.

On the supply side, yes, they have made certain assumptions about the level of supply from the North West Shelf. As Kevin has said, we continue to market gas, we continue to engage with customers to form new contracts and none of those price scenarios that are projected there actually recognise any of that continued activity. They make a very simple assumption that as contracts come to their natural end, we will simply not replace them; and that is not the truth.

The CHAIRMAN: They make a couple of scenarios. The worst case one is, as I understand it, that when the contracts come up they are not renewed and there are some assumptions about degree of renewal and it does not make fair assumptions.

One of the big issues here, which goes to how a firm like yours operates in markets—the North West Shelf is a mature operation. As I understand it, you have a lot of sum capacity in five trains and a domestic processing unit and eventually in the next decade you will have to source more gas to keep the facilities operating, which is what we would want you to do, I am sure. Where do you think you are going to get the gas?

Second— this is probably one of the crucial issues—it has at least been implied, if not stated, that big LNG companies have a bias in their operations to supplying LNG contracts as a way as opposed to domestic contracts—maybe not you, you have a different history of other ones, but is there something in the strategic reasons in the operations of LNG firms that cause them to give priority to export markets for LNG, maybe for monetarising their reserves quicker and more thoroughly, at the cost of domestic markets? So that is a two-part question; one relevant to your field and one generally.

Mr Gallagher: Okay, if I can take the first part of the question and address where the new gas comes from. I said up front that the North West Shelf venture participants had invested some $27 billion in capital investment over the 26 years or so that we have been operating. Just as an aside, another indicator of how cost bases have changed over that period in time, is that if we were to replace that today, that would cost over $50 billion to replace that infrastructure, but we have not stopped there. Currently we are planning to drill between two and three new exploration wells in 2011. That will be a spend in the region of $100 million with absolutely no guarantee of return—the nature of exploration. We do that to try to identify new gas reserves for the future as you advance. In addition to that, we are currently spending some $6 billion on current projects to install new offshore infrastructure. This infrastructure is designed to access both new and current reserves that exist within our depleting reservoirs, to help us access those reserves. These projects are designed to extend the life of the North West Shelf project. That is why we are spending that money today. As for the priority of LNG —

The CHAIRMAN: Excuse me. What is infrastructure? Pumping water to —

Mr Gallagher: Well, the biggest one we have, which is a $4.8 billion offshore project is the installation of a compression platform at our North Rankin facility—this would be the North Rankin 2 project—which then allows us to draw down the reservoir at lower pressures to get more reserves out of the reservoirs.

The CHAIRMAN: Another issue is when the North West Shelf—when you first agreed to the contracts in the late 1980s to now, have the total reserves been larger than expected?

Mr Gallagher: I think that would be true of all projects. In 99 per cent of offshore projects that would be the typical maturation curve that you would see from the projects as you increase your knowledge of reservoir and as you continue to explore. I cannot give you the specific numbers on that, but that is typically the case with most offshore developments.

The CHAIRMAN: Are the reserves often conservative when you start out, then you get to learn them and be able to, let us say, most sufficiently extract what is in there?

Mr Gallagher: It actually overlaps with the second part of the question because, as you can imagine, when you are making multibillion-dollar investments you do not want to be too gung-ho in your assessments and your assumptions when it comes to reserves. There is a natural tendency to be conservative to make sure that the economics will stack up for such large investments.

Just on the prioritisation part of the question, as I said earlier, I do not believe that the issue in WA is a domestic gas supply issue; the reserves are there. The issue is remoteness and a difficulty in developing these resources commercially. Typically, with these projects, the volumes required to be produced, and the rates of production required to allow a reasonable rate of return on such a project, cannot be absorbed by the Western Australian gas market. It just simply does not have the capacity to absorb those rates; hence, the reason that LNG contracts are required to underpin such multibillion-dollar investments. I can give you some numbers to help contextualise that point. An onshore LNG train with a capacity to process four to five million tonnes per annum will cost in the region of $5 billion to build and install. In addition to that $5 billion, you have your offshore support infrastructure costs which again run into the billion of dollars more often than not; transportation costs; and the customers who are receiving it have the cost of receiving terminals and re-gasification plant. Therefore, a very significant investment is required. This is the point where LNG production and domestic gas supply interconnect. That is why I referred earlier to the point that I believe LNG should be seen as an enabler for the domestic gas market development, as opposed to a threat.

Mr W.J. JOHNSTON: Could I just ask a question arising from that? I am sure you have read the Premier’s speech to the Baker Institute. I want to quote just one part from what the Premier said. It is on page 28 if you want to get it for yourself. “It” refers to gas —

> Moreover the price at which it is made available to the domestic market should not be above the effective price at which the gas is fed into the LNG plant.

Do you have any comments on that?

Mr Gallagher: I think on specific price questions I would like to defer that to the in camera session, if we can. I would say more generally that I believe it is the role of government to set policy that encourages investment and offshore gas developments, as opposed to regulating price in the market.

[1.00 pm]

The CHAIRMAN: I go back to the issue about the LNG market and the domestic market. You say that you do not see a strategic or financial imperative for firms to give priority to the LNG market over the domestic? Your firm is different; it has a different situation?

Mr Gallagher: I will reiterate a couple of points, then I will hand over to Ben to expand on. What I am saying is that, with the very large investments required to develop these remote offshore resources, the domestic gas market simply cannot sustain these projects on its own; therefore, you need both. There is a point at which you need the LNG contracts that underpin these projects to allow you to develop them to then supply to the domestic gas market. Do you want to add anything to that, Ben?

Mr Coetzer: If I can collect a couple of those points together. Firstly, the direct implication of having both domestic gas and LNG running concurrently is, with volume, you are able to reduce your overall unit cost of production. That brings us into an area where it is much easier to achieve a commercial outcome just through economies of scale. That is the first issue, I guess. The second issue is around the point at whether companies would defer gas production that they could potentially sell as domestic gas to keep it for later as LNG. While you correctly note the situation with North West Shelf is a little bit different, most companies, I suspect, would see little difference between the value of domestic gas today and LNG today. There is absolutely no incentive to defer that in terms of time, value of money. There is an incentive to sell domestic gas in addition to the LNG volumes, especially if they are co-producing any liquid products with that gas.

The CHAIRMAN: One of the issues you raise in your preamble, and that others have raised, is the restrictive structure of the industry in Western Australia; that is, there are few suppliers, few pipelines and few major buyers. That leads to regulation of the pipeline, and a lot of argie-bargie as rivalrous. We did a tour of the eastern states where it used to be that way, but it is not any more; it is a very interconnected, competitive market—obviously something we look at now with some jealousy. What policies would you put in place to get our market more competitive like the eastern states market?

Mr Gallagher: I would suggest that we need to increase diversity of supply in the market. Therefore, as I said earlier, I think the focus of policy should be very much on encouraging investment in the development of new offshore gas projects to bring new supply sources to the market. I think the market signals I have seen lately are encouraging inasmuch as we have seen positive progress on three significant offshore projects in Western Australia—namely, Reindeer, Macedon and the Gorgon project. That will take us to a place of five major suppliers to the market versus the two we currently have. Do you want to add to that, Ben?

Mr Coetzer: Kevin is correct in saying from the upstream perspective, the key development area for us is more independent supply options, because it will not only allow us a better functioning market as such, but also create a situation in which there is greater reliability of supply across the entire system—one of the items specifically picked up by the Gas Supply and Emergency Management Committee last year. Secondly, I think the other thing we need to remember is, because there is no day-to-day spot market or secondary market per se in Western Australia, it is very difficult to achieve any of the outcomes you are seeing in the eastern states. I think the model globally for that sort of market is probably the USA, but then we need to remember that it is very difficult to translate one market model in an economy that consumes 30 TCF every year to an economy that consumes about 0.3 TCF every year; we are talking one per cent of the size. The same market structure does not necessarily give you the same desirable market outcomes. We do not necessarily see a need for Western Australia to migrate to something like the eastern states or the US structure to still provide effective market outcomes.

Mr W.J. JOHNSTON: Earlier in answer to my question about reserve production ratios you said that it was difficult for you to answer because the individual joint venture partners have their own reserves. I think you also said they were selling those reserves. I assume that is in offshore markets. One of the arguments many people have put to us is that the joint venture partners are selling as a unit domestically, and that is holding back the market, whereas if you were not able to market domestically, that would improve our market here in Western Australia. Do have you a comment on that?

Mr Coetzer: I am happy to comment on that. I believe the determination by the ACCC in regard to our application for joint marketing authorisation covers that area pretty well. The ACCC came to a very clear conclusion that in no way did joint marketing by the North West Shelf venture participants result in any reduction of gas supply to the market or any observable increase in price in the market as a result of that. The ACCC in fact went a step further and said that, given the structure of the market, in fact, the ability to sell together is likely to bring greater volumes of gas to the market in a shorter time frame because it reduces the commercial uncertainty in the market and, therefore, allows us to more easily make those offshore investment decisions that we need to make to continue to supply the market.

The CHAIRMAN: Reservation policy probably has not applied to you, but I understand it is 15 per cent, negotiable and flexible to LNG projects. Has that impacted on your decision making? Do you think it is a relevant issue to ensure either gas actually flowing to the market or the predictability of gas flowing to the market? Do you have any comments on the reservation policy?

Mr Gallagher: Historically and currently, it has not impacted in the way we have operated this joint venture from the point of view that we have tried to avoid in any way, shape or form marketing gas to the domestic gas market. We spend around $1 billion per annum operating and maintaining our facilities in Karratha. It is an integrated facility, as you rightly pointed out, with five LNG trains and two domestic gas trains. We have invested very heavily in that infrastructure, and we intend to utilise that infrastructure going forward and continue to maximise our returns from that. We are still maintaining it and upgrading it and we are still spending as heavily as ever, if not heavier, than we ever have done in the past. In terms of going forward, I think it is also the case that, broadly speaking, a large part of the proved 1P reserves held by the venture participants have been allocated to existing contracts. I do not know whether Ben wants to add anything further to that.

Mr Coetzer: More broadly, on the reservation policy itself, as Kevin pointed out, it does not apply to the North West Shelf. We have requirements under the state agreement. One of the things to consider in doing that is that by essentially relying on new LNG projects to deliver your future domestic gas supplies, you are putting yourself up as a state at risk to the extent that the state of the international LNG market is not something we can predict with any certainty and should that market move in an undesirable direction, many of those projects may well not come to fruition. The second aspect to that is that the potential for very large volumes to enter the market under a prescriptive reservation policy, would be enough to scare off any development of smaller resources as dedicated domestic supply projects. As Kevin pointed out, one of the most encouraging things we have seen from the more recent price signals is the development of at least two dedicated domestic gas supply projects in the Reindeer development at Devil Creek and the Macedon approval by BHP Billiton and Apache.

The CHAIRMAN: This I guess is purely speculative. North West Shelf has five trains and, hopefully, will find more gas. Would you consider being a gas toller? Would you buy gas from somebody else, some other person not involved in the joint venture who finds gas and wants to process it through LNG and export it? Have you considered or discussed buying that gas, tolling it or processing it for them?

Mr Gallagher: One thing I pointed out earlier was that the facility at Karratha, the North West Shelf gas plant, is an integrated facility. As you point out there are five LNG trains and two domestic-gas trains. We produce a number of different products. The challenges with that are that the specifications of the plant are designed for those products and those product specifications, which limit the opportunity to then bring in third party products and it would make that not necessarily as easy as it may seem, so there are complexities associated with doing that. Would we consider it? At this point in time we do not have to, but, as I say, the technical difficulties with doing that are considerable.

The CHAIRMAN: You would struggle with your set-up, let us say, bringing Gorgon Gas in—completely hypothetically—because of the composition of the gas or because of the structural layout of the infrastructure. People in other places have suggested that we should look at tolling systems, so I am using you as an example—you have those facilities. Is this difficult in the LNG industry? Other places do it.

Mr Gallagher: The difficulty is you have to design your plant to do it. In some cases, plants are designed to do that from day one because that is part of the business model that has been set up when the investments have been made. We did not do that as part of our investment model when we built this facility because we had significant resources, so this would be a very current question. As I say, it is an easy argument to throw out into the public arena—an easy phrase to throw about. But it can be very complex and it can be very difficult, depending on the composition of the products you are trying to process. Ben, do you want to add anything to that?

Mr Coetzer: The only other thing I can add to that is that, although there are examples where tolling facilities produce pipeline gas, I am not aware of any LNG facilities globally that currently do that.

The CHAIRMAN: I thought there were some in Indonesia.

Mr Coetzer: That is done under a completely different fiscal structure where the upstream and downstream are separated by law.

The CHAIRMAN: That is right. By law?

Mr Coetzer: Yes. Again the gas composition from those developments have been the same. There are two separate producing ventures to my knowledge that have been there since the beginning, and they continue to supply.

The CHAIRMAN: So they were built with a fiscal and source structure?

Mr Coetzer: Yes. These plants are very much bespoke to the resource that they are used to develop.

Mr Gallagher: It is important to add to that these are not five LNG trains with five different sources coming onshore. As I say, it is an integrated facility, one source coming from offshore and processed through five LNG trains and two domestic gas trains.

Mr J.E. McGRATH: You mentioned earlier, Mr Gallagher, that the role of government should be to encourage more competition in exploration and development of fields and things like that. It seems to the layman there is a lot of exploration and development going on with all the new projects up there. How much potential is there? There has been some evidence to the committee that a lot of the fields have already been reserved by the bigger players and there is not much room for others to move in. How do you see the situation up in the basin and around that area?

[1.15 pm]

Mr Gallagher: Well, I would challenge the view that it has all been reserved, given the amount of exploration activity that is currently going on. Obviously a lot of people believe there is prospectivity out there or they would not be spending the very significant exploration budgets that they are spending today; that activity is going on. We, ourselves, are exploring next year, as I have already pointed out. So I would challenge that view. But my view on policy is that the government has a role in policy setting, obviously; my view is that that should be to encourage further investment as opposed to taking the stance of trying to control the price. My fear would be that, by price regulation, you could drive that investment away and not see the levels of investment we are seeing today. I think the signals are positive. As I have said already, we are seeing three major developments coming to the market; that is a very positive signal and it is an unprecedented supply response. For the Western Australian domestic gas market to go from two main suppliers to five major suppliers over the next four or five years is quite a shift.

Mr J.E. McGRATH: You mentioned, also, the North Rankin development, and you talked about a time period there and that they might extend—Perseus and the Rankin fields—through to 2040. What supply commitments to dom gas and LNG have you based this projection on; and, also, how expensive will this gas be to develop relative to previous production that has been undertaken by the joint venture partners?

Mr Gallagher: They are two very good questions.

Mr J.E. McGRATH: Thank you.

Mr Gallagher: Let me start just by saying that the first part—well, let me go to answer the second part first. The development costs: with any field, as you get to the point where your reservoirs start depleting, the new fields you are bringing on, or the new reservoirs, tend to not be the biggest and best or you would have developed them first; they have been developed. The unit costs of development do increase, coupled with the large increases that we have seen in recent years of labour costs, contractor contracts, operating costs—those costs will continue to increase. We are seeing that; we are seeing very significant increases. I will give you one or two examples: we have seen an about 220 per cent increase in the price of steel in the past few years; I could give you an example of drill rigs that we lease. Five years ago, we were leasing for about $US90 000 a day; it is currently in the region of $US450 000 to $US500 000 a day. Our development costs, our finding costs, and our lifting costs are increasing, so you are absolutely right to point to that. That becomes an issue for us. We do believe, however, that these projects are still viable—well, certainly the ones we are investing in today we believe are viable or we would not be investing in them. Yes, you are right to point out the fact that we are attempting to extend the life of our field out to 2040.

As far as commitments to contracts are concerned, as I said we have domestic gas contracts in place right now that go beyond the end of this decade, but beyond that who knows what the world will look like then; we will be competing in a different world. But we are continuing to market domestic gas today beyond our current commitments, and we intend to continue to do that.

The CHAIRMAN: Those cost increases that you mentioned, especially for the drilling, what is causing those? Is it a temporary phenomena, or is it just demand for rigs—people will respond by building more rigs, I assume?

Mr Gallagher: Yes, it comes back to the comments on any free market, really, it is supply–demand. As the oil price increased a few years ago, so did the price of services; the demand outstripped supply and we are where we are. One of the interesting issues for the Western Australian gas market is that we often pay more for our contractor rates here than we do in different parts of the world; again, that is the remoteness effect on the market. Just because there are less suppliers here, less contractors here, we tend to get charged more for those services.

The CHAIRMAN: You hear in the papers, at least, that the north west of Western Australia is one of the most expensive places in the world to build, whether it is a large mining project or LNG or gas; is that your experience?

Mr Gallagher: Yes.

The CHAIRMAN: So not only are costs rising around the world, but also the rigs —

Mr Gallagher: Yes; the higher activity in recent years has been a global phenomenon and so costs have gone up worldwide, as have the commodity prices that have driven the investment into the market. Western Australia, though, is still a relatively remote operations environment compared with other more mature regions like the Gulf of Mexico, even west Africa and South America to some extent, so some of those services command a premium in this part of the world. That said, it is one of the most exciting provinces in terms of resources in the ground, but, as I said earlier in my opening statement and again reiterated, that is one of the challenges that we have; it is not supply of gas in Western Australia, it is the remoteness that makes it challenging to commercialise.

The CHAIRMAN: You would have heard about the recent explosion of the rig in the gulf, and there was a leakage and explosion up north here—it was a smaller operation, but nonetheless significant.

Mr Gallagher: Yes.

The CHAIRMAN: Is the regulatory response to the threats and risks associated with deep drilling going to impact on our North West Shelf? Is the industry responding in some way?

Mr Gallagher: Yes, I think the industry generally has responded, and I would say, on behalf of North West Shelf, that our record has been second to none over the 26 years that we have been operating both from a safety and environmental perspective. We put safety and environment at the very top of our priority list in our operations. We do expect some changes to legislation in the major regions around the world, and we are expecting a paper from the legislator here in Australia—the federal government—by the end of this year, or close to the end of this year. I do expect some changes, and will they affect us? They will affect everyone operating offshore, particularly in the drilling arena I suspect.

The CHAIRMAN: I think we should go to in camera. We are going to go to an in camera session now, and so we would everybody to go and have some coffee or water outside.

[The committee took evidence in camera]