# Existing Long Term Gas Supply and Transportation Contracts – a Major Barrier to the Emerging Market

*Address to*

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# A) Introduction

Australia has embarked on a journey to radically change its energy industry. Most would agree that a move to a free and fair energy market would significantly enhance Australia's competitiveness. It has been repeatedly demonstrated that free markets result in an efficient and healthy industry – regardless of the commodity or service of interest. The energy industry is of particular interest since the lowering of energy costs lead to a decrease in the prices of outputs from other industries, thereby strengthening national competitiveness. In the emerging global economy, any and all factors contributing to competitive advantage will have to be exploited. The objective of this paper is not to debate the merits of this journey, but to examine some of the implications on the gas industry should we acknowledge that we are on such a journey.

While the Australian economy is increasingly enjoying the benefits of increased competition in the wholesale and retail electricity markets, it is unclear what kind of gas industry will emerge from this period of unprecedented industry restructuring. A patchwork of unfolding national and state reform initiatives has put the restructuring of the gas industry in motion, but, in my opinion, the gas industry has a long way to go before it begins to resemble electricity, oil, LNG, LPG, coal, and other forms of energy. A cornerstone that seems to be missing from the gas industry restructuring initiatives is the lack of a wholesale bulk gas market. The development of a wholesale gas market has been delayed pending the restructuring of existing gas supply and transportation contracts to achieve fair and equitable risk sharing under the proposed new market structure.

I will speak to some of the ways in which the restructuring of the traditional long-term gas supply contracts that have historically dominated Australia's gas industry can create a win/win situation. But first, I'd like to share some observations for your consideration regarding the divergence of Australia's gas industry from the electricity industry and indeed from the remaining energy industry. Such divergence, if allowed to linger, will result in market share loss for the gas industry. I've already shared my views on the benefits of a free and fair market, but I'd like to first share my views on where we are today in the competitive restructuring of the gas industry, and what remains to be done to make this one of the most successful chapters of economic reform in the history of this great country.

## B) Gas Reform Report Card

Gary Hamel's statement that "the future has already happened, it's just not evenly distributed" seems very appropriate today in Australia's gas industry. Our best guide to the future of the industry lies in where we are today and what we have learned from experiences in other competitively restructured industries. Successful restructuring of any commodity related industry has involved first the creation of a robust wholesale market and then moved on to greater and greater retail competition. Australia has to date ignored this principle. The savings to consumers diminishes as one goes from the wholesale market reform to retail market reform due to the greater complexity and size of the transactions intrinsic to this sector of the value chain.

The North American gas market is without a doubt the most sophisticated and efficient gas market world wide and yet robust competition at the retail level of the market is but emerging – some ten years after the introduction of competition at the wholesale level. A thorough cost / benefit analysis was performed on the gas industries of Canada and the U.S. by their respective governments revealing better than expected results some ten years after de-regulations initiatives and industry restructuring in the late 1980's. The following are but a sample of the impressive statistics associated with the North American gas industry:

- With about 17 percent of the world's potential gas resources, holds only about 6 percent of proved gas reserves
- In 1996 the average netback gas price to the producers plant gate was US$1.81/MMbtu compared to US$1.15/Mmbtu for the rest of the world
- 26 Tcf of gas demand in 1996 compared to 77 Tcf worldwide
- Delivered prices to end users among the lowest in the world

- 45% growth rate projected by 2015

Source: 1997 Enron ENERGY OUTLOOK

Many other gas markets, including that of the UK and Europe, are striving to restructure with similar objectives as was that of North America and is now that of Australia. They have to date experienced various degrees of success. Many are ahead of Australia in deciding to re-structure their respective gas industries to a free and fair trade competitive market, yet many are stalled in the implementation stage. The old adage "the devil is in the detail" seems to be of relevance. I wonder how Australia's report card will look in a few years time, given the barriers to competition that remain in the gas industry.

Without a doubt, Australia's gas industry is inefficient as bench marked against world's best practice. Retail competition is a good goal for global competitive forces and customers demand supplier choice and greater value offerings. Open access on transportation and distribution pipelines is also represents good progress but in isolation will not result in a gas market. A market is characterised by price discovery, liquidity via a sufficiently deep spot market, standardisation of contractual terms and operational procedures, numerous efficient and effective risk management tools, and often a forward market. Commodity markets have volatile prices; especially electricity and gas. Market participants are subject to supply / demand fundamentals as market clearing prices become king. Cost based rates and open access for all transmission and distribution services on an unbundled basis facilitates competition with respect to commodity and capacity trading. Furthermore, an efficient industry is one exhibiting efficient use of capital and a level playing field for all participants throughout the value chain.

While a commodity market has emerged in the electricity industry in most eastern Australia states, the gas industry remains hostage to producer cartels as is evidenced by monopolistic pricing and other anti-competitive contractual terms at the wholesale level. To date the industry has been focused exclusively on open access issues and the introduction of competition at the retail level. This seems to be cosmetic and will no doubt lead to much frustration and disappointment given the fact that there is but one shipper on most gas pipelines and that 99+% of the gas transactions in the wholesale bulk market are conducted under what may be referred to as non-contemporary contracts.

Regarding the transportation of gas through transmission pipelines, only two pipelines in Australia conduct their business on a truly non-discriminatory basis – namely PG&E Qld and AtlintaGas Transmission. All other pipelines have refused to re-structure their transportation contracts with shippers so that all users are charged the same rate for the same or similar service. To not do so results in major distortions in the market.

Current and proposed legislation does not address this fundamental flaw in the market structure. The market carriage model proposed for Victoria addresses the need for a level playing field regarding transportation and although the recent renegotiation of the gas supply contracts with Esso/BHP are an improvement, most industry advisers believe that they will severely hinder the implementation of the proposed market model. Western Australia commenced the re-structuring of long term supply contract with its dis-aggregation initiative in 1994. This re-structuring was primarily that of unbundling the major end users from the gas utility.

## C) The Divergence of Gas and Electricity in Australia

Unlike the electricity industry, in which generation, transmission, and distribution assets have been generally owned by state government, the economic structure of the gas industry historically has been one of little vertical integration and a mixture of state, federal, and the private sector. Consequently, producers sold gas under supply contracts to either a gas utility (WA, NSW, Victoria, & ACT), large end users directly (Qld), a pipeline company (SA), or a state owned power generation company (WA, SA, Victoria). Gas was transported on either government owned or privately owned transmission pipelines to either the city gate or in the case of Qld directly to major end users under long term transportation contracts. Since, until recently, no economic regulation was in existence, the buyer had to, in theory, negotiate a toll with a monopoly pipeline company. In reality, the pipeline company dictated the terms, including the toll, and the buyer had little recourse but to either agree upon the terms or exit the gas industry.

These contracts were long term in duration (10 to 30 years) and contain many terms and conditions which although quite appropriate at the time, are not consistent with an open and competitive market. Such contracts materialised after drawn out negotiations and reflect, among other things, the power struggles and insecurities present at the genesis of the industry. Although the majority of these contracts date back to the late sixties and early seventies, a few have been added in the late nineties. Unfortunately for Allgas Energy Ltd many of the more recent ones pertain to Queensland.

Instead of dealing with this issue, regulators have elected to uphold the sanctity of contracts regardless of the cost. Industry participants have to date generally been either unwilling or unable to re-structure such gas supply and transmission contracts to reflect the emerging market conditions. As previously mentioned, in my opinion, only PG&E Qld, AtlintaGas, and the Gas Reform Unit of Victoria have addressed this major barrier to open competition. Most of the efforts have been targeted in the transmission area. I suggest that buyers and shippers have little, if any, leverage for initialising the re-structuring of contracts. At present it rests with the attitude of producers and pipeline companies and with the fortitude of state and national regulators.

This lack of resolve in the gas industry has not been adopted in the electricity industry – which leads to the statement that, unlike the rest of the world, the industries are diverging in Australia at the present. The electricity industry has addressed both transmission and power purchase agreements (PPA's) in a very timely and effective fashion.

Historical long term gas supply contracts between producers and buyers are analogous to historical PPA's of 20 to 30 years in duration and that used to pass the risk of inadequate market demand for electricity and any adverse change in price to the electric distributor and ultimately the consumer. Such contracts were viewed early in electricity reform as inappropriate, terminated, and replaced with 'vested' contracts. "At the commencement of the electricity market, the distributors and generators were vested with bilateral hedge contracts which effectively fix the prices between them for quantities representing a substantial proportion of their average electricity generation / consumption, but still leaving a proportion to be traded on the variable spot market. The vested quantities automatically reduce over several years to be replaced by bilateral contracts negotiated by the participants or spot market purchases."[1]

Contemporary PPA's are priced at the market, thereby forcing generators, old and new, to accept margin risk – not only in relation to the recovery of capital and operating costs but also fuel to electricity price spread. This has led to the recent large scale sale of generation assets by vertically integrated electricity utilities in the US. Power generation assets are no longer risk free and therefore divestment by low risk utilities to those with risk management competencies is appropriate. Contemporary Cogen and IPP developers require different skills from that historically required for a tolling based plant. A large proportion of sales from new plants are merchant based and therefore exposed to the market.

Although most of the electricity industry was state owned and therefore easily

[1] Power in Australia by Minter Ellison

restructured by government led electricity reform groups, two new privately owned gas fired cogeneration plants illustrate well the pitfalls of historical PPA's in the new market while a third illustrates the pitfall of purchasing fixed price gas for power generation as opposed to at the market. Integral Energy purchases gas from the new Sithe owned and operated 160 MW Cogen located at Smithfield, NSW under a 25 year PPA at $50 million per year. Integral Energy has recently reported that the market worth of the power has fallen to about $20 million per year. Integral admits that the project has become a "financial handicap". The second example of involves ETSA and its PPA with the new Boral Energies / CU Power International owned Cogen located at Osborne, S.A. ETSA has recently stated that the contracted price under the 15 year PPA is much higher than market and has consequently taken a $98.8 million write-down on its 1996-97 accounts as an extraordinary provision against the PPA. The third lesson also involves Integral Energy and gas. Integral has expressed financial difficulties due to its agreement to purchase 98MW of power generated from the conversion of coal seam methane at BHP's Appin / Tower coal mines. The power project is a Lend Lease / EDL joint venture and illustrates the fuel spread risk associated with gas priced independent of market forces.

Unlike electric distributors and vertically integrated electric utilities, commercial and technical risk is not new to gas producers. They are often the first to state how risky their business is and how they bet on commodity cycles. Most petroleum producers price hedge very little, if any, of their production. Furthermore, the gas industry is not as capital intense as the electric and it involves primary production as opposed to the conversion of a feed stock fuel to a secondary energy form. Thus the commercial risks associated with the exploration and production of gas in a restructured competitive gas industry are far less than that facing electric power generators in a similar environment.

Regarding transmission, the electricity code stipulates the services and tariffs for the use of the wire capacity. Unlike, gas, no user contracts were in place prior to the implementation of electricity reform. In the pool structure or market carriage model selected for the electricity market, each and every facility user of the transmission wires is charged the same for any particular service; a fundamental principle in order to achieve an efficient market. Again, the gas industry, with the exception of Victoria, has selected an alternate path. The selection of a contract carriage model where capacity is contracted for and traded in a secondary market, while different, can facilitate an efficient and competitive market as has been demonstrated in North America. Two models for electricity versus gas will in my view always lead to some inefficiencies for those wanting a seamless energy market. The major issue, however, is the loss in gas of the principle that for commodity market forces to work, freight costs associated with monopoly infrastructure such as gas pipelines must be common for all market participants. Otherwise competitive advantage is distorted for commercially, transactions remain bundled. The wholesale bulk market cannot function and trading hubs do not evolve. This would be tragic for Australia.

## D) What a Gas Market looks like:

A healthy market is characterised by the easy entry and exit of buyers and sellers. Long term contracts with rudimentary risk sharing and risk allocation provisions create tremendous barriers to entry, as exists in Australia's current gas industry. Such trade barriers frustrate new entrants as there is no hope of even discounting to purchase market share since they are at the full mercy of the incumbents and their contracting arrangements. A spot market essentially provides a clearinghouse role. Such a clearinghouse is an efficient mechanism for the closing or settlement of contractual obligations, be they financial, commodity trading, or transportation services.

In North America the spot price is extensively used to quickly settle temporary defaults in transportation balancing and supply or delivery firm obligations. "Spot markets are a normal mechanism by which commodity traders reconcile imbalances of supply and demand when, as, and if they occur. For example, spot markets in crude oil, petroleum products, and coal are generally within the range of 15 percent to 30 percent of overall consumption".[2] As the gas market of Australia becomes increasingly competitive the value of various positions will change more rapidly than in the past, thereby favoring shorter term arrangements. A portfolio of contracting arrangements which include a sizeable portion of spot enables adequate levels of both liquidity and stability in any given market.

A second need which a spot market satisfies is an efficient price discovery mechanism. A market must have a physical cash component form which floating or market prices are confidently derived. Furthermore, buyers and sellers in the brave new world of a competitive gas market will need current gas pricing information at various locations along the value chain in order to adequately informed regarding the economics of each decision facing them. Inter-regional price relationships

[2] *Commoditization of North American Gas Markets: Trading Gas - Trading Capacity* paper by Benjamin Schlesinger and Associates, Inc; Executive Enterprises Inc. Natural Gas Futures Conference, September 20, 1993, Houston Texas, page 4.

develop and regional pricing inefficiencies tend to evaporate given a robust spot market. Any given spot market, in order to confidently discover the market price, must have sufficient depth in terms of number of transactions and participants and must be of sufficient size to not be overly influenced by the actions of any given participant. Such price discovery allows for the confident correlation of various regional spot markets or as is the case in North America - gas hub indices. In the brave new competitive world any given market participant is unlikely to survive very long to the extent that the price of gas is either above or below the market for any sustained period of time. As hedging simply transfers risk, short-term forward markets will simply eliminate price shocks associated with price volatility.

Upon sufficient confidence by financial institutions in such price discovery and liquidity, a futures market may or may not develop pending the volatility exhibited by any given commodity and the size of the market. It is interesting to note that gas has been the most volatile commodity introduced on NYMEX prior to electricity. Furthermore, there is a great deal of pricing flexibility and price efficiency when sales and purchases associated with a physical portion of a commodity market are indexed to a liquid underlying hedge index. The ultimate power of this structure is provided by the ability of either counter party to freely fix, float, or adjust its pricing structure in a number of other ways independent of each other. In other words, transactions become highly efficient due to wider contestability of many more components of each gas deal.

An economically efficient and competitive market is characterised by a spectrum of diverse contracting arrangements and the efficient management of risks associated with physical delivery of the commodity and price.

> *Efficient management of risk, including risk due to price volatility, is one of the functions that competitive markets perform well. In a highly evolved commodity market, there will exist a diversity of contractual forms and options, which permit the risk of price volatility to be transfered to those parties who can bear the risk most efficiently. This diversity of contractual forms is absolutely necessary for market participants to be able to hold portfolios of supply options that yield a better combination of risks and prices than can be*

[3] *Oversight of Regulated Utilities' Fuel Supply Contracts: Achieving Maximum Benefit From Competitive Natural Gas and Emission Allowance Markets,* by Adam B. Jaffe and Joseph P. Kalt of The Economics Resource Group, April 1993, page i.
[4] *Commoditization of North American Gas Markets: Trading Gas - Trading Capacity* paper by Benjamin Schlesinger and Associates, Inc; Executive Enterprises Inc. Natural Gas Futures Conference, September 20, 1993, Houston Texas, page 3.
[5] Ibid, page 4

*achieved through sole reliance on spot pricing*[3]

While this study was performed to examine the dangers of the dominant U.S. spot market, a sole reliance on long term contracts with escalated pricing and infrequent price re-openers is, in my opinion, an even more dangerous situation. Until a paper market exists for gas, market participants will have to manage risks either internally through vertical or horizontal integration or commercially by pursuing a portfolio of contractual terms which diversify its mix of price and supply reliability.

A spot market has the potential to substantially minimise transaction costs to the industry. This, however, may not be realised immediately since like many good things there may be some short-term pain prior to longer-term gains. The transaction costs are linked to such other factors as the synchronisation of the necessary gas transportation arrangements. While many have criticised Victoria's gas industry restructuring model as too complicated, I submit that the market model purposed for the rest of Australia is far too simple and is not principle centred. The major flaw in Victoria is the fact that traditional long term gas supply contracts exist with Esso-BHP for 98 percent of the state demand.

A spot gas market was established in 1983 when thousands of 30-day spot gas contracts quickly flooded into the market. "By 1988, more than 300 natural gas marketing companies were in business, and approximately three quarters of all gas consumed in the U.S. was derived in spot markets at one point or another in the supply chain that year."[4] By the 1990's, the U.S. gas market had stablised to a steady state with a healthy mixture of long term, medium term, and spot transactions - all market based. Gas trade in 1991 was estimated to be as follows:

*Spot (1 day - 1 week) transactions - 5%*

*Spot (30-day) transactions - 40%*

*Medium-term (less than 1 year) - 20%*

*Long-term (greater than 1 year) - 35%*[5]

Even the conservative gas utilities have drastically changed their gas purchase behaviour as is illustrated by the largest US gas utility, namely SoCal Gas. SoCal Gas has restructured its gas supply purchases from essentially long term to the following portfolio of interstate gas supplies:

30 day spot – 94%

Long term – 6%

## E) Long Term Gas Supply Contracts – Traditional Versus Contemporary

Although most of Australia's resource development industries are accustomed to the notion that market forces drive investment decisions, for some reason the upstream sector of the gas industry has been sheltered from such principles. Historically, long term gas supply contracts have underwritten the development of gas fields and transmission / distribution infrastructure – not unlike the PPA's of the electricity industry. Such arrangements were typical of first generation contracting procedures worldwide. However, gas supply contracts with producers have evolved significantly in many other regions of the world as traditional contracting methods have been replaced with more contemporary procedures. It has been generally accepted that such an evolution has delivered much mutual benefit to all stake holders.

### Pricing

To date, producers in Australia, like in Europe, are reluctant to allow gas to gas competition. Producers have priced gas on a market bearable basis having due regard to cross fuel competition at various points in time. Pipeline companies have had a similar approach to pricing. Such pricing practise has led to expectations that prices rise each year with CPI. Furthermore, neither long run nor short run marginal cost have any influence on prices. Such a pricing methodology has led to annual increases in ex-plant gas prices in most contracts since the genesis of the gas industry in 1969. Furthermore gas prices ex-plant seem to have little to do with other contractual terms. Although price re-opener options exist from time to time, buyers have, based on past experiences, become reluctant to revisit price. In the absence of price transparency and discovery, the process of establishing a new gas price becomes very subjective and any particular buyer is disadvantaged vis-à-vis the producer in this regard. Buyers as large as AGL have become disillusioned with price re-negotiations.

Contemporary contracts are either very short term with fixed non-escalated prices or are longer in term with market based pricing arrangements. As the market evolves such pricing terms vary from alternate fuel parity or gas to gas competition on a delivered basis and net back pricing to the well head to a purely index relationship in the most mature of gas markets. The use of published indices results in the efficient use of financial instruments and the forward market to apply price risk management. Prior to the development of well established posted prices based on a deep spot market, often gas prices are expressed in demand / commodity structure in order to unbundle fixed and variable costs. Fixed costs would be paid for regardless of gas quantities taken. In the upstream E&P business fixed costs would be a rather small percentage of the total price as exploration costs are considered sunk at the time of gas sales and processing cost are largely variable. This is in direct opposition to pipeline costs which tend to be mostly fixed until capital is depreciated.

In contemporary gas supply contracts there are many price related terms that are precisely priced and available to select from. Such terms include the following:

- *Delivery Point*
- *Swing or Load Factor*
- *Commitment to Perform*
- *Term*
- *Market risk*

The value of gas delivered to a specific point may or may not at any time equal the transportation cost. This adjustment to price is commonly referred to as geographic basis and should be set by supply / demand forces. The value of deliverability swing can be priced based on fuel switching, gas storage, etc to reflect the value of an option on deliverability. Price adjustments based on commitment to perform would vary significantly depending on whether the contract was firm (either reasonable or best efforts) and interruptible (as available).

It is well documented that commodity markets are cyclical and that real prices decline over time. For this reason, while producers tend to command a premium price for gas sold under long term contracts, all things being equal, long term contracts for larger volumes of gas should command lower prices than those on shorter term contracts or for smaller volumes. The lower price can be justified on the grounds that there is significantly less market risk to the producer. Furthermore, should prices be fixed or escalated over the longer term, discount pricing is again justified based on price certainty benefits (a price hedge) to the producer.

## Market Risk

Traditional gas supply contracts contain take-or-pay provisions that guarantee revenue over 10 to 30 years to the producer and therefore underwrites not only gas field development capital but also often ensures the recovery of sunk exploration costs, operating costs, and a profit margin. Such minimum off take guarantees often cause economic hardship to buyers, especially at times of seismic changes in the structure of the market. For this reason costs associated with take-or-pay have been earmarked as stranded costs in many regions around the world and dealt with as market transition costs. Such costs are usually shared among industry participants or dealt with by government.

Take-or-pay arrangements in Australia are particularly onerous for the following reasons. Should a buyer be unwilling or unable to purchase sufficient quantities of gas under such contracts and thereby incur take-or-pay, the buyer is forced to pay for gas at full price and accumulate an inventory of pre-paid insitu gas. Not only is the price of such gas ridiculously inflated since no operating costs were incurred by the producer, but the buyer's recovery of such gas is subject to operational and contractual constraints. Often the producer gives no reserve nor delivery guarantee under such an event.

Such arrangements clearly result in major distortions to the gas market. Producers remain isolated from market forces and buyers behaviour is driven by fears of incurring banked pre-paid gas accounts at inflated costs. To the extent that the buyer is subject to market forces either in reselling the gas or in the sale of a derivative product, there is no sharing of such risk.

Contemporary gas supply contracts share market risk pursuant to well defined procedures applicable to any commodity market – oil, electricity, coal, gold, iron ore, wool, grain, etc. Take-or-pay would exist only in the form of a demand or reservation charge at a fraction of the total cost of gas. In the late 1980's such charges were called gas inventory charges (GIC's). The North American gas market has matured to the state where even GIC's are difficult to find. Gas is bought and sold at market clearing prices and therefore volume, price, and revenue guarantees are non-existent in contracts between produces and counter parties.

**Security of Supply**

In traditional gas supply contracts great assurances are derived from the dedication of either proven gas reserves or exploration / production licence areas for security of supply purposes. Such dedicated supplies are audited and monitored by buyers and the producer's obligation to perform is reduced to the installation of sufficient gas gathering lines and gas processing plant to meet its delivery commitments. Geological and recovery risk is passed on to buyers under such arrangements. It is rather interesting to note that buyers readily accept such risk while producers are so uncomfortable with it that they are reluctant to guarantee the recovery of prepaid banks of insitu gas and to balance from time to time the interests of the joint venture should they market gas separately and therefore not draw down reserves on a pro rata basis.

Contemporary contracts recognise that there is little value in suing gas molecules and therefore rely on liquidated damages or well defined financial compensation for various types and degrees of non-performance. Since a deep market provides the best security of supply; there is no need to touch and feel the underground stock piles of gas resource. Furthermore, it has widely recognised that just-in-time inventory practices reduce industry cost and therefore should be encouraged. This is especially important in such a capital intensive industries such as gas. The availability of gas will always exist in an open market – it's just a matter of at what price. Under such an environment counter party risk is most important and the producer is left to run the upstream business without interference from buyers.

**Term**

Traditional gas supply contracts vary in term from 10 to 30 years with extension provisions. Since the economic pay out of the development of gas fields post the discovery of gas is in typically less than 5 years, it is difficult for producers to insist on such long terms. Terms of 15 to 20 years are often justified for transportation contracts relating to transmission and distribution due to the long depreciation schedule and tight economics of such investments. In the early stages of the development of a gas industry and associated infrastructure in any continent, it is not unusual for buyers of gas from producers to insist on long term gas supply contracts due to the lack of gas supply alternatives.

As time passes and as markets reform, the types of gas supply contracts change – they become much shorter in term and standardised. In fact under normal market forces a vibrant spot market develops as previously described. Spot markets become highly efficient to the extent that prices are bench marked, contracts are standardised, and the trading process is transparent. Such is the case of the spot pool model adapted in the electricity industry.

## F) Win / Win Solutions

It is important as always to generate a win /win solution. The following attempt to do so is based on a perspective gained while working at the following major gas players:

- One of the top ten gas producers in Canada – Alberta Energy Company Ltd
- The largest gas pipeline and energy trading company in the US – Enron Corp
- BHP Petroleum
- Allgas Energy Ltd

The effective restructuring of long term gas supply and transportation contracts is not an easy task for quid pro quo's will be difficult to find for every clause requiring change and every newly introduced concept. This process took some time in North America. It is therefore important that every major stake holder recognise their win.

While Australia based producers will probably not agree with me at this time, they are surely one with the most to gain – especially in the longer term. The many benefits to gas producers include the following:

- Rapid gas usage growth with increasing competitive pressures – primarily in the feed stock, large industrial, and power generation sectors
- Reduced cycle times with commensurate increase in profitability – even at lower field prices
- Liquidity allows efficient balancing and backstopping – thereby reducing reserve plant margins
- Market forces lead to more efficient patterns of investment
- Industry efficiency improvements via improved innovation and creativity

## G) Conclusion

Much is at stake! The piecemeal gas reform initiatives to date are not sufficient. Among other things, they ignore many of the principles associated with and the pre-requisites of free and fair markets. Gas reform represents an important opportunity to enhance Australia's competitiveness and to level the playing field between states and territories.

Historically the state with the most indigenous gas and the most consumer oriented gas supply contract with the producer had a clear advantage in attracting gas intensive industries or attaining windfall profits, as the case would be. The continental gas market of Australia is akin to that of Europe or South America, in that each state or territory has historically behaved in a parochial manner with little to no consideration for the collective benefit of the nation or continent.

The historical long term gas supply and pipeline transmission contracts remain a major impediment to moving forward to achieve the objectives of the Hilmer Report and the CoAG Agreement. For regulators the message is that while sanctity of contracts is a noble statement, the majority of Australia's long term gas contracts are not appropriate for the espoused post reform market structure. The message for industry is that now is not the time to be defensive and to hang on to the status quo. Rather it is time to move boldly to forge an open market, in which competition and choice are the rules and not the exception.

The incumbent producers and pipeline companies must make a contribution. A robust wholesale gas market is a pre-requisite to all other reform initiatives. To ignore this principle tends to makes a mockery of the whole process and invites cynicism. I am confident that this oversight will be corrected. Markets must be viewed as forces to be worshipped rather than a tool to be manipulated. Allgas Energy Ltd is one company who believes that the adoption of a win/win and innovation based paradigm will lead to mutual benefit among all industry participants.

Thank-you.