

# The Role of Gippsland Basin Gas in NSW Markets

Presented by

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## **I. Introduction**

The original long term gas supply contract that underpinned the development of the NSW market as we know it today is abating. Gas reforms are sweeping across Australia promoting increased competition and economic efficiency. Offshore Victoria gas in general, and Gippsland Basin gas in particular is well positioned to play a major role in satisfying the growing gas demand expected in NSW over the future decades. The restructuring of the market into one of multiple sellers and multiple buyers, all of which have effective access to pipeline transportation and other essential facilities, will in my view, stimulate growth in both the upstream and the downstream sectors of the gas industry. Furthermore, such second generation supply and marketing arrangements may be radically different from those available in NSW today.

Is this just a "pipe dream" for the offshore gas producers of Victoria? Who might be the industry players capable of and/or motivated to making all this happen? BHP believes that such a restructuring of the market is in the overall best interest of Australia and that similar to the rest of the world, gas will play an ever increasing role in satisfying the future domestic primary energy demand. There are several changes, paradigm shifts, that are occurring in the gas industry that, in my view, are going to lead to a very different future for all energy forms and associated players in Australia as we move into the next century. In fact the possibility of Gippsland Basin gas entering the NSW market over the next few

years has already made a significant impact on the future of both the gas and electricity markets of NSW.

You may ask "Where do these thoughts come from?". In order to appreciate why Gippsland Basin gas is destined to play a major role in the NSW market, it is important to understand BHP's corporate perspective regarding the importance of a healthy domestic gas industry, some worldwide and domestic observations regarding the structure of the industry, and some observations of the gas industry in NSW. It is important to note that the views stated in this paper reflect my own and not necessarily those of BHP or BHP Petroleum.

## **II. The BHP Perspective**

BHP, Australia's largest publicly owned company, is an international resource company with headquarters in Melbourne but operations worldwide. BHP has become one of the world's largest diversified resource companies, with three major businesses, namely mining, steel, and energy industries, all of which rank as significant by worldwide standards. Most of the commodities which BHP either mines or manufactures compete effectively with those of world best practice companies in a free trade, highly competitive, and often global marketplace. BHP as both a major energy user and hydrocarbon producer, has a major vested interest in gas, particularly the domestic gas industry. BHP Petroleum is Australia's largest producer of oil and gas with significant natural gas reserves in the Gippsland, Otway, and Carnarvon Basins and exploration activity in several other offshore basins. BHP Minerals has significant coal bed methane resource in the Bowen Basin. BHP Steel ranks among the top three gas consumers in eastern Australia and BHP Minerals is quickly growing into the largest gas consumer in Western Australia. As gas emerges as the preferred hydrocarbon fuel in many industrial and power generation applications, BHP expects gas to play an even larger role in meeting its energy needs of the future. As a consumer, we look forward to the creation of an open, dynamic gas industry that is more customer focused and offers a choice of gas supplier and contractual features.

BHP Petroleum is similar to other major petroleum companies around the world in that it has historically had a passive role in gas infrastructure and market development, and has found it necessary to re-examine and change its role as the dawning of the "Age of Gas" approaches. The basis for such limited involvement in activities downstream of the gas processing plant gate include: the historical view that gas was a "waste product", the severe regulatory environment associated with such activities, the emergence of separate pipeline and reticulation companies, the statutory monopolisation of gas marketing by utilities, the long cycle time of gas, and the regional nature of gas markets. As the economic climate of the oil business changed, the gas industry has grown in stature in the eyes of petroleum companies. It is increasingly important for petroleum companies such as BHP Petroleum to pay due attention to the gas side of the business to ensure survival, growth and prosperity in the future. Before the allocation of capital expenditures for gas targeted exploration and production activities, petroleum companies require more market

confidence than mere reliance on third party agents such as pipeline companies and reticulators. Furthermore, the often excessive profits enjoyed by midstream and downstream players with low risk exposure have become unacceptable to petroleum companies and consumers alike.

BHP Petroleum, as well as many of its competitors, owns huge imbalances of gas in terms of reserves to production ratio. Such an extended cash flow lag after exploration and production capital expenditure leads to poor economics. The commercialisation of such static gas reserves is a major growth platform for BHP Petroleum and will necessitate a major emphasis on market development and the promotion of economically efficient gas related infrastructure. Consequently, BHP Petroleum is looking at the gas business beyond exploration, production, and marketing to include transportation and distribution infrastructure, gas feed stock projects, and gas fired power generation. BHP Petroleum plans to aggressively pursue the domestic and regional gas market in a similar manner to its pursuit of the export market as is evidenced by its Liquefied Natural Gas (LNG) operations.

### **III. Gas Industry Background**

It is important to understand that historically worldwide, gas was discovered by petroleum companies in their search for oil, a product historically marketed aggressively by those same companies. Gas was once considered a byproduct of much less value, and consequently the gas industry was largely developed by non-resource owners such as pipeline and reticulation companies, often with heavy government involvement or influence. Such companies bought long term gas supplies and built the necessary infrastructure to sell to end users, often forming a monopoly. The fact that gas, like electricity, cannot be readily transported or stored reinforced such monopolies or franchises. In Australia government involvement was through the ownership of most pipeline and reticulation companies. Recently such companies have been either corporatised or privatised to conform with Australia wide gas reforms. It is anticipated that new infrastructure will largely be funded and operated by the private sector under commercial arrangements in a pro-competitive regulatory regime. Government involvement in other countries was often through strict regulation of privately owned monopolies.

The gas industry is one of the most capital intensive industries in the world, with large production and transmission infrastructure sectors. This results in a gas market that is very regional in nature; expanding geographically only when infrastructure depreciates. Because gas is a relatively low cost, highly combustible, environmentally friendly fuel, it has been gaining an increasing share of the world's primary energy market each year and now averages approximately 25%.<sup>1</sup> Countries that are significant gas producers are generally at or above the world average. Countries that have little to no indigenous gas production are generally below the average. Surprisingly, although Australia is blessed with abundant gas resources insofar as it is a large exporter of gas in the form of LNG,

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<sup>1</sup>BHP Petroleum, *Fuelling the Future*, December 1993 Federal Government Briefing Seminar, p. 3.

Australia overall and the state of NSW in particular have relatively low gas penetration of primary energy demand: approximately 18% and 8% respectively.<sup>2</sup> Australia is estimated to have 1.43 Tcm of total recoverable gas resource as of 01/01/95 of which 39% or 0.56 Tcm is proved reserves. The total Australian gas market in 1994 is estimated at 17 Bcm. This results in a proved reserve life index of over 33 years compared to under 9 years for the US and approximately 15 years for Canada. Australia's resource life index of over 84 years compares to 66 years for the US and 93 years for North America.<sup>3</sup> Furthermore, as has been experienced around the world, Australia has since the 1960's has continued to have enough "new" gas discovered or proved up to not only offset production but also maintain reserves-to-production ratios at higher demand levels.<sup>4</sup>

The domestic gas industry is far from the economic efficiency levels achieved in other parts of the world, even though Australia enjoys among the lowest gas exploration and production costs in the world and gas resources are located in relative close proximity to major markets. Such evidence suggests that market development has been stifled by the lack of low cost transportation and reticulation infrastructure and/or excessive price mark-up by monopoly retailers.

Currently the domestic gas markets are sharply geographically delineated. With the exception of Western Australia, each major market has been supplied under long term contracts from a single producing basin via a single pipeline, with no more than two markets being supplied from a single basin. The concentration of players in each regional market further exasperates the situation. This structure has not been conducive to the development of market responsive gas services, and has resulted in excessively high delivered prices to consumers for a rather inflexible product. Gas reticulators with monopsony market power may have initially marketed gas well to build up their service area, but soon, due to the lack of competition, reverted to simply selling gas. Without competition the selling of gas by utilities often degenerates to focusing on the gas meter or the regulator as the customer as opposed to the consumer, little, if any, market segmentation, and a general focus on the needs of the utility as opposed to those of the consumer. Gas marketing, in contrast, focuses on the needs of the buyer or consumer, creates value added services or offerings as a result of creativity, intuition, and innovation, and highly segments the market. Gas marketing in the very competitive North American gas market of today is sophisticated; involving brand products and the extensive utilisation of financial and physical risk management tools. Contracts and services are tailor make to best fit market niches.

The negative impact of the domestic gas industry structure on national economic growth was documented by the Industry Commission Inquiry of 1991, and subsequently identified by the Federal Government as a target for urgent reform. A key principle of this reform

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<sup>2</sup>ABARE Research, *Australian Energy Consumption and Production - Historical Trends and Projections to 2009-10*, Report 95.1, 1995, Canberra, ACT, pp. 10-12.

<sup>3</sup>Enron Corporation, *The 1995 Enron Outlook*, 1995, Houston, Texas, pp. 1,3,7.

<sup>4</sup>The Australian Gas Association, *Gas Supply and Demand Study*, CPN Publications, Fyshwick ACT, 1992, p. 18.

has been the promotion of increased levels of competition throughout all stages of the gas chain. Reform has been implemented through vehicles such as the Hilmer Inquiry, which recommended a framework for minimising anti-competitive practices on infrastructure assets that represent natural monopolies. The Council of Australian Governments has approved the universal adoption of principles designed to break down parochial, protectionism practices preventing free and fair trade in gas within and across state boundaries. The key thrust of reform has been aimed at the creation of gas-on-gas competition within each gas market. Increased competition in eastern Australia in our view will occur only after the creation of an interstate pipeline grid to physically allow gas to flow from supply basins to major markets and the effective access to essential facilities owned by gas reticulation companies.

A recent government bench marking study has found that the domestic gas industry is rather efficient except for reticulation. The study states the following: 'The US city-gate price, on average, may be about 11 percent higher than the Australian city-gate price.'<sup>5</sup> 'Despite Australia's overall advantage in terms of city-gate prices, in 1991 the average price of industrial gas was 24 per cent lower in the US than in Australia.'<sup>6</sup> 'US prices for commercial gas are on average 26 per cent lower than the average Australian price for commercial gas. Likewise, the average US price for residential gas is about 22 per cent lower than the average Australian price.'<sup>7</sup> The rate of return on gas assets enjoyed by both the Gas & Fuel Corporation of Victoria and the Australian Gas Light Company was in 1991 more than twice that of Enron Corporation, the American gas utilities giant.<sup>8</sup>

Without effective access to markets and the opportunity to market gas directly to end users domestic gas exploration and production companies such as BHP Petroleum will have to either rely on additional LNG projects and the export markets of Asia or curtail domestic gas related capital expenditures in favor of alternate continents. In the absence of low cost freight, long term security of reasonably priced gas supply, and tailor made contract terms and conditions as provided by an efficient and competitive industry, consumers such as BHP Steel and BHP Minerals have excessive energy costs and are discouraged from the use of gas. Furthermore, gas feed stock plants become increasingly less competitive in global commodity markets and gas fired power generation opportunities never materialise. BHP fails to see how an increasingly unhealthy upstream sector or a dying stifled market can in any way be good for Australia.

#### **IV. The NSW's Perspective**

The gas market in NSW originated in the Sydney area and was developed with town gas which the Australian Light Company (AGL) and its subsidiary companies manufactured from coal and later petroleum. In the mid to late 1960's negotiations were held between

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<sup>5</sup>Bureau of Industry Economics, *International Performance Indicators Gas Supply*, Australian Government Publishing Service, December 1994, Canberra, ACT, p. 36.

<sup>6</sup>ibid., p. 38.

<sup>7</sup>ibid., p. 39.

<sup>8</sup>ibid., p. 85.

AGL and two prospective long term gas suppliers, namely the Gippsland Basin and the South Australian Cooper Basin joint venture consortiums. A 30 year gas supply agreement with the S.A. Cooper Basin consortium was completed in 1970 and a 1300 km 152 PJ's per annum fully compressed capacity pipeline was built and placed in service by late 1976.<sup>9</sup> With the exception of the Albury market which is supplied by Gippsland Basin gas via the Gas & Fuel Corporation of Victoria, the remaining NSW market (approximately 98%) has been and continues to be supplied by the original Cooper Basin gas supply contract. Unless extended, this supply contract with AGL expires in September of 2006 and contracted quantities decline commencing in 2001.<sup>10</sup>

AGL aggressively developed the NSW/ACT gas market from approximately 10 PJ's in 1977 to a high of approximately 101 PJ's in 1987.<sup>11</sup> As the sole provider of gas supply and the sole provider of low pressure gas pipelines and metering to approximately 98% and 96% of the NSW market respectively, AGL arguably performed well over this period as the marketer of gas and provider of related services to customers. The NSW market, excluding Albury, has shrunk to approximately 95 PJ's per annum today, and the price of gas delivered to end users has increased substantially since 1987.

As the historical gas supply contract with AGL declines and eventually expires, and as the NSW market is restructured and consumers begin to demand the benefit of supply choice in a competitive marketplace, there will be several supply options for the NSW market in the future. The NSW government of 1993 discovered that 'the main participants in the gas industry, both producers and distributors, appear to share the expectation that the NSW market will obtain gas from the Gippsland and the Cooper/Eromanga Basins in the medium term.'<sup>12</sup> Additional gas supplies for NSW may be economically sourced in the future from a number of sources including:

- offshore Victoria; one or more of the Gippsland, Bass, and Otway Basins
- central Australia; either or both of the Cooper/Eromanga and Amadeus Basins
- Eastern Queensland; either or both of the Surat/Bowen Basin or Coal Bed Methane (CBM)
- NSW CBM

As the gas infrastructure in eastern Australia evolves into a gas grid that physically connects all supplies to all markets, it is conceivable that gas from any of the above supplies will be consumed in NSW in the future. In 1993, based on AGA demand

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<sup>9</sup>The Gas Council of NSW and the Office of Energy with the participation of the ACT Chief Minister's Department, *Joint Study on the Long Term Supply of Natural Gas for New South Wales - Report to the New South Wales Minister for Energy*, June 1993, pp. 55 - 56.

<sup>10</sup>Trade Practices Commission Review of Authorisation No A90424, *AGL Cooper Basin natural gas arrangements*, Issue Paper, June 1995, Attachment 1, p. 83.

<sup>11</sup>The Australian Gas Association, *Gas Industry Statistics 1994*, June 1994, Canberra ACT, p. 23.

<sup>12</sup>The Gas Council of NSW and the Office of Energy with the participation of the ACT Chief Minister's Department, *Joint Study on the Long Term Supply of Natural Gas for New South Wales - Report to the New South Wales Minister for Energy*, June 1993, p. 114.

projections of the NSW market and the AGL Cooper Basin gas supply contract, the NSW government concluded that 'it now appears unlikely that additional gas will be required by 2001.'<sup>13</sup> However, market forces under a reformed gas market place may significantly impact the timing of alternate gas supplies into the NSW market. The new entrants will, in my view, be decided based on cost and service advantages. The incumbents, namely AGL and the Cooper Basin producers, have been dictating terms to the NSW market for nearly 20 years and may be at a severe disadvantage to innovative, customer focused, low cost new entrants.

Unlike the mature and declining producing onshore basins of Australia, the offshore Victoria basins include the new discoveries of the Otway Basin and the world class reserves and deliverability characteristics of the Gippsland Basin. Furthermore, unlike CBM, which is a discovered yet uncommercial non-producing resource, the Gippsland Basin has more than 6000 PJ's or 50% of the overall eastern Australia supply of proven and probable gas reserves. These gas reserves are not only discovered and commercial, but the majority have capital intensive production infrastructure in place. This gas is located a mere 700 km from the AGL reticulation system serving the major NSW markets. Although in due time as the appropriate technology improvements and/or cost reductions materialise, other gas supplies such as CBM and new offshore discoveries will also compete for the NSW market, the time has come for the Gippsland Basin to play a much larger role in supplying the NSW market beyond the municipality of Albury.

Perhaps the most important consideration in this matter is the consumers' perspective. Ironically, studies are often conducted and plans made without truly consulting those who ultimately pay the bills of the industry - the consumer. As has been discussed, this voice that has been silenced in the past is erupting with growing empowerment pending the success of gas reforms in Australia. As the North American gas industry deregulated into one of free and fair trade, the two most powerful market forces that changed the industry beyond most expectations were, in my view, the new entrant gas marketing companies and the consumers, particularly the large industrial users, gas feed stock companies, and gas fired power developers.

The various segments of the market have quite specific needs, many of which I believe will pull Gippsland Basin gas into the NSW market. The residential and commercial market sector, often referred to as the tariff market, is composed of small volume consumers. Such consumers use less than 10 TJ's per annum and account for approximately 25% of AGL's NSW market or approximately 24 PJ's per annum in 1993.<sup>14</sup> The Gas Council of New South Wales regulates this sector byway of a price control formula. Due to the low usage per customer inherent to this market sector, the delivered price of gas is by far the highest. Next to price, long term security of gas supply is usually of paramount concern to both these customers and the industry in general due to the long capital investment depreciation requirements given the lack of economies of scale. It is often considered

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<sup>13</sup>ibid., p. 56.

<sup>14</sup>The Gas Council of New South Wales, *Gas Prices in NSW - Proposed Haulage Agreement Following the Sale of the Moomba to Sydney Gas Pipeline System*, pp. 9 - 10.

prudent to require at least 10 years of contracted gas supply cover to protect consumers and the industry against the risk of stranded assets. Since the current contracted supply expires in 2006, Gippsland Basin gas is able and willing to enhance the long term security of supply for this sector of the NSW market.

What is referred to as the contract market in NSW is the aggregate of those customers who use more than 10 TJ's per annum. Such customers are industrial companies and constitute 75% of AGL's NSW market or 71 PJ's per annum in 1993.<sup>15</sup> Although this sector is currently dominated by BHP Steel and Incitec, approximately 18 other industrials also use enough gas annually to warrant a high interest in the procurement of gas supplies directly from producers. BHP Steel is the largest gas user in NSW at 17% of the contract market and 12% of the total market of NSW. BHP Steel has purchased gas from AGL since 1979 as an oil replacement both for process and heating applications. Although gas costs have remained below that of oil, the pricing of gas on a market bearable basis has resulted in a substantial extraction of economic rent from BHP Steel to date for infrastructure and procurement costs. Such accumulated rent far exceeds the cost of servicing BHP Steel, resulting in a cross subsidy of services required for other markets and handsome profits to AGL. High energy costs makes it difficult for BHP Steel to compete in domestic and global steel markets. Industrial customers located in NSW, such as BHP Steel, are looking forward to being able to purchase gas, as they do other materials, in an open market. This results in an opportunity for Gippsland Basin gas as an alternative gas supplier.

Incitec, the second largest end user of gas in NSW, is the only gas feed stock industry and uses 8.5 PJ per annum in the conversion of methane into ammonia.<sup>16</sup> 'Gas cost is 90% of the variable cost of manufacture of ammonia and 70% of the total costs including fixed costs.'<sup>17</sup> Incitec's international competitiveness has deteriorated significantly, for its gas feed stock prices have increased over time insofar as it is at a severe disadvantage vis-à-vis overseas ammonia manufactures.<sup>18</sup> Frustrated by the lack of choice, Incitec states: "Obviously an aggregator role is necessary in the tariff market, however, large users with different contractual requirements should have the option and the easy right to contract directly with producers and transporters."<sup>19</sup> Again Gippsland Basin gas may play a vital role in the creation of choice and sustainable competitiveness for Incitec at its Newcastle, NSW ammonia production operations.

A third market sector that has been almost nonexistent in the NSW market to date is gas-fired power generation. Power generation is the fastest growing gas application worldwide for a variety of reasons, not the least of which are environmental advantages over alternatives. Applications range from small (10 MW) to large (200 MW) site specific

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<sup>15</sup>ibid., p. 9.

<sup>16</sup>Incitec, *Gas Policy Statement - a View by Incitec*, dated 13 December 1994, p. 2.

<sup>17</sup>ibid., p. 6.

<sup>18</sup>Industry Commission, *Australian Gas Industry and Markets Study*, Australian Government Publishing Services, Canberra, ACT, 1995, p. 29.

<sup>19</sup>Incitec, *Gas Policy Statement - a View by Incitec*, dated 13 December 1994, p. 10.



cogeneration plants that combine the production of usable heat and electricity to large independent power production plants. It is BHP's view that competition, free trade, and effective access to infrastructure will make gas-fired power generation and cogeneration much more attractive and available in the NSW market. Such projects are often owned and constructed by private power developers, such as BHP Power, who, for project financing and/or financial risk management purposes require a long term gas supply contract with predictable pricing on a delivered basis to fix margins against power sale and steam sale contracts. It is very difficult for a reticulator or any other party who wishes to pass through its cost of gas and/or transportation over time to become a gas supplier to this important market sector. Gas producers and sophisticated marketing companies who have mastered the use of financial instruments are in the position to manage and therefore accept the risk of selling long term predictably priced gas. BHP Petroleum has already demonstrated this by securing a 20 year contract to supply the new 150 MW cogeneration plant that is under development by Sth Energies Australia Pty Ltd at Smithfield, NSW. This plant is expected to be commissioned in 1996 and consume 10 PJ's per annum thereafter. The vast reserves owned by BHP Petroleum in the Gippsland Basin, and the confidence that such gas will soon have access to the NSW market, gave BHP the confidence to underwrite this project from a gas supply perspective. The gas-fired power generation/cogeneration market, BHP believes, will constitute the major growth in the NSW market over the next 10 years. Latent gas demand in NSW such as power generation can best be unleashed via an open market.

## **V. Conclusion**

Although there exist some restraining forces to Gippsland Basin gas expanding its role in the NSW market in the near term, BHP Petroleum believes that the forces in favor of Gippsland Basin gas playing a significant role in that market are overwhelming. As BHP Petroleum gets more involved in downstream gas activities, as the domestic gas industry reforms to one of free and fair interstate trade, and as the voice of NSW consumers demanding the benefits of choice regarding their gas supply are heard, Gippsland Basin gas will play an ever increasing role in the NSW market. A government study to evaluate the benefits of allowing Gippsland Basin gas into NSW markets quantified the net present value of the efficiency gains to the industry of such an action at \$406 million over the 35 years of the study.<sup>20</sup> Many other qualitative benefits such as: security of supply, end user specific contracts and services, and a healthier industry will also be afforded by Gippsland Basin gas increasing its role in the NSW market.

Gippsland Basin gas freely available in the NSW market is just one aspect of a whole new world for the Australian gas industry. I think we're going to see some significant changes in our industry in the future that are going to be very positive. For the first time in Australia we'll find a relatively efficient gas industry, from supply through to market. Both consumers and producers will find renewed confidence in the gas industry and make the necessary investments to turn the industry into a vibrant and growing one. Gas is a great

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<sup>20</sup>ABARE, *The Economics of Interconnection: Electricity Grids and Gas Pipelines in Australia*, ABARE Research Report 93.12, Canberra, ACT, 1993, p.44.

product - one of Australia's best arsenals in the fight for global competitiveness. It's inexpensive, it's domestic, it's clean and it's flexible!

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### **Abstract**

The Gippsland Basin, located offshore Victoria, contains more than 50% of the known proven and probable or high grade gas resources of Eastern Australia. This basin competed with the Cooper Basin of SA in the mid to late 1960's to supply gas to the NSW market via the Australia Gas Light Company under a 30 year gas supply contract that commenced in 1976. To date Gippsland Basin has supplied gas to only the municipality of Albury in NSW or approximately 2% of the 95 PJ per annum total NSW market. The NSW market today is characterised by high delivered prices, little consumer choice, and much latent demand. Australia wide gas reform is well underway with a primary objective to drive economic inefficiencies from the industry. The greatest economic inefficiencies discovered to date seem to be the price charged for gas services from the city gate to the end users' purchase meter by reticulators. Market forces under a reformed industry will, in my view, cause additional Gippsland Basin gas to be utilised in NSW markets well before the previously predicted date by the NSW Gas Council of 2001. The future NSW gas market should involve unprecedented growth, investment, and innovation. Gippsland Basin gas as the primary alternate gas supply to the current supply arrangements will play a major role in the introduction and maintenance of competition in the NSW market. The result will be a healthier more robust gas industry in Australia for all participants present and future.



