

AiG Proposal to Reserve Australian Natural Gas for Domestic Use

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ITS GLOBAL

International Trade Strategies Pty Ltd, trading as ITS Global
Level 1, 34 Queen Street
MELBOURNE VIC 3000
AUSTRALIA

Tel: +61 3 9654 8323
Fax: +61 3 9654 4922
<http://www.itsglobal.net>

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Executive Summary

The Australian Industry Group (AiG) has proposed that the Commonwealth should approve all significant investments in LNG processing capacity but only when it is satisfied that:

- There will be an ‘adequate supply’ of gas for domestic uses.
- The project is in the ‘national interest’.
- The proponents have ‘adequately considered’ both domestic and export opportunities.

The AiG has not proposed criteria for determining when these tests are met. It sees the approval process as involving a public inquiry into the impacts of the prospective investment on the economy and on domestic energy prices but has given no guidance as to how they should affect any decision.

A well-functioning market economy is the best insurance that market outcomes are in the public interest, are adequate for domestic consumers, and do not discriminate between domestic and foreign consumers. For the domestic supply of gas to be internationally competitive, Governments need to cut the regulatory and tax burdens on the sector, rather than add to them as AiG proposes.

For the Australian community, the proposal would deliver costs but no benefits.

- It would impose transaction costs that would discourage investment and job creation. The most serious is the cost of investment delay — in terms of GDP foregone — which could be up to \$5.5 million per day.
- It would encourage ‘rent seeking’ by gas users, environmental NGOs, and politicians.
- The opaque nature of the process and the scope for delay and rent-seeking would worsen Australia’s sovereign risk and discourage essential foreign investment in LNG processing.

The AiG proposal is protectionist. It would inhibit investment, job creation and export expansion in gas production, while encouraging inefficient local energy use.

Adoption of the AiG proposal would put our international relationships at risk by:

- selectively increasing the existing restrictions on foreign investment;
- not complying with Australia’s FTAs with the US and NZ;
- signalling an unwillingness to liberalise foreign investment bilaterally, including when negotiating FTAs; and
- most probably not complying with Australia’s WTO obligations.

The AiG appears to have given little thought to the implications of its proposal for public administration. It is not clear how the assessments against the three tests and the associated public inquiries would be conducted or who would conduct them. These are important issues for public administration for which there are no obvious solutions.

1. The AiG Proposal

Exports of liquefied natural gas (LNG) from Queensland are due to commence in 2014 and are expected to reach 25 million tonnes per annum (Mtpa) by the end of the decade.¹ Over this time period the combination of the emergence of large-scale exports of LNG, rising costs of recovering, transmitting and distributing natural gas to domestic users in Eastern Australia, and substantial regulatory barriers which impede the development of onshore gas resources in NSW and Victoria are expected to put upward pressure on domestic gas prices.

Given this outlook, the AiG has concluded that Australia needs 'to ensure that export and domestic uses of gas are, and are seen to be, complementary'.² To this end, the Group proposes that the Commonwealth Government should approve all significant investments in LNG processing capacity but only where it is satisfied that:

- There will be an adequate supply of gas for domestic uses.
- The project is in the 'national interest'.
- The proponents have adequately considered both domestic and export supply opportunities.

The rest of this briefing paper critically examines the implications of this proposal for the Australian economy and the Australian community as a whole.

¹ BREE [Bureau of Resources and Energy Economics], 2013, *Resources and Energy Major Projects: April 2013*, Bureau of Resources and Energy Economics, Canberra, 22 May.

² AiG [Australian Industry Group], 2013, *Energy shock: the gas crunch is here*, The Australian Industry Group, 26 July, p. 20

2. Consideration of the Issues

The AiG has proposed no criteria for determining ‘adequate supply’, the ‘national interest’ or ‘adequate consideration’. It has merely said that the approval process should assess ‘the national consequences’ of each prospective LNG project, ‘particularly its economic consequences’ and give the public and gas users ‘visibility and voice’ in that process.³ While the AiG sees the process as addressing the impacts of prospective LNG investments on domestic gas and electricity prices, it has given no idea how such impacts should affect the Government’s decision.

Empirical research and historical experience confirms that an economy that is based on economic freedom, the rule of law, secure and alienable property rights, and open competition provides the best insurance that its various outcomes are in the public interest, are adequate for domestic consumers, and do not discriminate between domestic and foreign consumers.

While gas producers want to get as high a price as possible and gas users to pay as little as they can, gas sales will only proceed at prices that are profitable to both parties — and therefore beneficial to their shareholders, their employees and — through resource taxation revenues — the general public. As Australia has a relatively small number of gas producers, it is important for governments to keep the regulatory barriers to entry low, rather than add to them as AiG has proposed.

The ability of domestic users to buy gas at prices that reflect its opportunity cost is the most defensible definition of the ‘national interest’. Any departure from this would be less economically beneficial for the Australian community as a whole. While some could gain, their gain would only be at the expense of others. To ensure an internationally competitive price for gas to domestic users Australian Governments need to reduce the regulatory and taxation burden on the gas sector, including its development of onshore gas resources. The Fraser Institute’s annual survey of mining executives around the world suggests that there is much to be done in this regard in most Australian jurisdictions.⁴

The specific shortcomings of the AiG proposal are canvassed in turn below.

2.1 Proposal has costs but not benefits

The imposition of the highly bureaucratic process of approval proposed by the AiG would be costly for the Australian economy and community. The reasons are three-fold.

Firstly, the proposed approval process will impose significant transaction costs, a large part of which would fall on the domestic gas industry.⁵ These costs would discourage future investment and the jobs that it would create. At the present time the gas industry has \$200 billion investment on new projects currently under

³ AiG 2013, p. 20

⁴ Alana Wilson, Fred McMahon, and Miguel Cervantes, 2013, *Fraser Institute Annual Survey of Mining Companies 2012/2013*, The Fraser Institute, Vancouver, BC

⁵ Transaction costs are incurred in searching out, negotiating, and enforcing an economic exchange and are to be distinguished from ‘transformation costs’ in producing the good or service that was the subject of the transaction.

construction, which were responsible for an estimated 100,000 jobs across the Australian economy last year and over the next 20 years, Australia's natural gas industry has the potential for a further \$180 billion in investment and the generation of some 150,000 new jobs.⁶

The most serious transaction costs are the delays that the approval process would necessarily impose on LNG investments. For a \$20 billion investment — the scale of the Queensland Curtis LNG Project — the cost of delay could be up to \$5.5 million per day.⁷ Contrary to what the AiG has suggested, a public inquiry that allowed enough time for substantive submissions from any interested party would take at least six months so the costs of delay are likely to be very substantial.⁸

The Commonwealth Government already approves most foreign investment based on a national interest test and following an assessment by the Foreign Investment Review Board (FIRB).⁹ A key point to note in this regard is that applications to the FIRB are often withdrawn prior to it completing an assessment and some of the withdrawn applications are then revised and resubmitted to the FIRB.

We would expect that something similar would occur under the AiG proposal, which would compound the cost of delay. Some of the withdrawn applications would not proceed and the investment in question would be lost to the economy altogether. Although it may be feasible for the prospective investors to amend their application in ways that would ensure approval, they may decide that the time and expense in doing so was not worthwhile, given the uncertainty.

In addition to the cost of delay, there will be the resource costs for government in administering the approval process and for the private sector in participating in their public inquiries. The participation costs are likely to be particularly burdensome for the prospective investors as they would be expected to provide virtually all the information required by the assessment.

Secondly, the nature of the approval process would encourage 'rent seeking'.¹⁰ Gas users could use it to seek to force down domestic gas prices and environmental NGOs to inhibit onshore gas development or expansion of LNG exports. The Government might require prospective investors to modify their application to the Government's political advantage — for example, by accepting a lower price for local gas sales. Ultimately such outcomes would be a cost to the community as a whole.

⁶ APPEA [Australian Petroleum Production & Exploration Association], 2013, 'Economic Benefits', *Our Natural Advantage*, Australian Petroleum Production & Exploration Association, Canberra [Accessed at <http://www.ournaturaladvantage.com.au/>]

⁷ This is based on the opportunity cost of deferring the net present value of the benefits of such an investment, which is at least \$20 billion. At a discount rate of 10 per cent the cost of deferral is more than \$2 billion per year.

⁸ This is the shortest time for public inquiries by the Productivity Commission on similar policy issues. The AiG has proposed that the Government's decisions should be made within six months of application (Appendix, AIG 2013).

⁹ There are exceptions [see http://www.firb.gov.au/content/downloads/AFIP_2013.pdf]

¹⁰ In public choice theory, 'rent-seeking' is any political or social activity that seeks a return for land, labour or capital, which is more than the minimum needed to keep it in its current use. It is contrasted to profit-seeking activity, where people seek to create value via mutually beneficial transactions.

Finally, the opaque nature of the proposed approvals process and the scope for delay and rent-seeking would exacerbate Australia's sovereign risk. This would discourage foreign investment, particularly in the highly capital-intensive LNG sector. Such investment facilitates the technology transfer and business innovation that are crucial to productivity growth and rising living standards.

2.2 Proposal represents trade protectionism

The AiG proposal amounts to the imposition of export controls on gas and represents a return to the 'bad old days' of the trade protectionism that heavily burdened the Australian economy for much of the 20th Century. Open and competitive product and factor markets together with sound macroeconomic and fiscal policies are the best and most reliable ways of developing local industry.

As we have seen, the proposed approval process will impose transaction costs on new LNG capacity and is therefore equivalent to taxing gas when it is exported and using the revenue to subsidize its domestic use. Neither proposition makes economic sense and their combination is doubly unfortunate. A regulatory 'tax' on LNG exports would discourage investment, job creation and expansion of trade in the gas sector with knock-on effects for the rest of the economy.

The production of natural gas in Australia does not generate economic rents that could be 'taxed' without affecting activity in the sector.

- Any rents are highly site-specific and marginal deposits do not yield any.
- Rent is the reward to the entrepreneurial foresight that drives business innovation and productivity growth. If there were no rents in petroleum and mineral development, there would be much less investment and many fewer jobs in the mining, oil and gas sectors.
- The States and Territories already collect a share of such rents on behalf of the public through the imposition of resource taxes.

Furthermore, it makes no economic sense to subsidize domestic usage as it would adversely affect the economic efficiency of domestic energy markets. Gas would tend to be used excessively as its local price would be less than its opportunity cost to the community.

Subsidization would also encourage gas to be substituted for other domestic energy. Some of that would be immediate — for example, electricity generation from gas would displace some coal and hydro-generation. Others would only occur after a lag — in industrial and household heating substitution would only materialise as burners and furnaces were replaced.

Substitution driven by price subsidization would impose an economic cost on the Australian economy, as it would increase the cost of energy use and distort its composition, thereby generating deadweight losses for the economy as a whole.

2.3 Proposal a risk to international relations

Adoption of the AiG proposal would put at risk Australia's international economic relationships with China, Japan, South Korea and the US. Investors from these countries have already made substantial investments in our LNG sector. Moreover, China, Japan, and South Korea are all major customers for Australian LNG exports and are expected to take most of the output from future expansions in processing capacity.

Adoption would selectively increase the restrictions placed on foreign investment, which are already among the toughest in the OECD.¹¹ In addition it would:

- not comply with Australia's free trade agreements (FTAs) with NZ or the US;
- signal an unwillingness to liberalise Australia's foreign investment regime bilaterally, including when negotiating FTAs; and
- most probably not comply with Australia's World Trade Organization (WTO) obligations.

The Commonwealth already has to approve foreign investment in excess of specified thresholds as being in the national interest.¹² In the LNG sector, approval is required where the investing entity is:

- privately owned in NZ or the US and proposes to acquire a substantial interest in an Australian business valued at more than A\$1,078 million;
- privately owned outside of Australia, NZ or the US and proposes to acquire a substantial interest in an Australian business valued in excess of A\$278 million;
- owned or controlled by a foreign government — regardless of the value of the investment.

The higher limits for the US and NZ are the result of the FTAs with those countries. Australia is currently negotiating similar agreements with China, Japan and South Korea —so the option to extend the higher threshold is a distinct possibility. Australia's international partners are therefore likely to strongly oppose adoption of the proposal. Their opposition would ultimately be expressed through WTO and relevant bilateral dispute settlement processes.

Contrary to what AiG has implied, there are WTO disciplines on policy measures that restrict exports. Article XI:1 of the General Agreement on Tariffs and Trade (GATT) states that there shall be 'no prohibitions or restrictions other than duties,

¹¹ The OECD's FDI Index measures the restrictions imposed on FDI by 55 countries. It indicates only Japan, NZ, Mexico, Iceland and Canada are more restrictive than Australia (OECD, 2013, *FDI Regulatory Restrictiveness Index*, Organization for Economic Co-operation & Development, Paris [accessed at: <http://www.oecd.org/investment/fdiindex.htm>])

¹² The thresholds vary by type of owner, country of origin and destination industry sector [see <http://www.firb.gov.au/>]

taxes or other charges...on the exportation...of any product'.¹³ While doubts have been expressed historically about the effectiveness of the WTO export disciplines, the most recent jurisprudence — such as the *China-Raw Materials case*¹⁴ — suggests otherwise.¹⁵

2.4 Proposal more restrictive than Canadian or US regimes

Under Canadian and US law a Federal agency has to approve all exports (or imports) of natural gas in each case. The tests that each agency uses, however, are quite different to what AiG has proposed for Australia. In both cases the test is much less restrictive than what AiG has proposed.

In Canada the National Energy Board has to be satisfied exports do not exceed that needed for foreseeable domestic demand, given the trends in discovery of new gas resources in Canada. The Board aims to encourage development of new markets for Canadian gas and thereby increase its availability for local use.¹⁶ Its focus is on gas resources — not gas supply as the AiG has proposed.

In the US the Secretary of Energy has to approve all applications to export natural gas unless, after a hearing on an application, the Secretary finds that the proposed exportation would not be consistent with the public interest.¹⁷ In contrast the AiG seeks to reverse the onus of proof by requiring investors to prove that their LNG projects are in the national interest — a more demanding test than that used in the US.

The US Congress has determined that any gas exports from the US to a country with a Free Trade Agreement with the US have met the public interest test and that such applications are to be granted without modification or delay.¹⁸ The AiG has made no such allowance in its proposal.

2.5 Proposal raises implementation issues

The AiG appears to have given little thought to the detailed implications of its proposal for public administration. The only guidance the AiG has given on this issue is to propose that an 'independent board' with 'broad expertise in gas production, marketing and industrial use' should 'consider' the 'material' from the assessment of each prospective LNG project against the three tests and the public inquiry held on the project. On this basis of this 'material' the proposed board would 'make recommendations' on the project to the Commonwealth Treasurer.¹⁹

¹³ GATT Article XI:2(a) exempts temporary restrictions to address critical shortages of products essential to the exporter.

¹⁴ WTO, 2013, *China - Measures Related to the Exportation of Various Raw Materials*, WT/DS394/R, WT/DS395/R, and WT/DS398/R

¹⁵ Robert Howse and Tim Josling, 2012, *Agricultural Export Restrictions and International Trade Law: A Way Forward*, International Food & Trade Policy Council, Washington, DC

¹⁶ National Energy Board, Canada [Accessed at: <http://www.neb-one.gc.ca/clf-nsi/rcmmn/hm-eng.html>]

¹⁷ See section 3 of the *Natural Gas Act*, 15 U.S.C. § 717b, and section 301(b) of the *Department of Energy Organization Act*, 42 U.S.C. § 7151. The process used to assess applications is outlined by the Department of Energy in: <http://docs.house.gov/meetings/IF/IF03/20130618/101000/HHRG-113-IF03-Wstate-SmithC-20130618.pdf>.

¹⁸ See section 3(c) of the *Natural Gas Act*, which was inserted by the *Energy Policy Act* of 1992

¹⁹ AiG 2013, Appendix

The AiG is silent, however, on how the assessments against the three tests and the related public inquiry should be conducted and on who should conduct each of these activities. Although the AiG has not volunteered answers to these questions, they raise important issues for public administration for which there are no obvious solutions.

The AiG clearly intends its approval processes to apply to all foreign investment in all LNG projects and not just to those that exceed the current thresholds. To minimize any inconsistencies of treatment with other foreign investments, the FIRB would probably have to undertake the foreign component of any LNG assessment. The alternative of having one agency to handle the entire process would be likely to create inconsistencies in treatment between foreign and domestic investors. It is, however, hard to agree that the FIRB would be the appropriate agency to undertake the domestic assessment, particularly if it is to involve a public inquiry.

Putting the foreign investment issue to one side, the Productivity Commission would be best placed to conduct the overall assessment and the associated public inquiry. That said, the idea of having completely separate assessments — one of the LNG proposal as a whole by the Productivity Commission followed by a FIRB assessment of any foreign investment component — looks like a potential administrative and political nightmare. Such sequencing would add to the risk of delay, to the point where it could constitute an impenetrable barrier for prospective investors.

3. Conclusion

A well-functioning market economy is the best insurance that market outcomes are in the public interest, are adequate for domestic consumers, and do not discriminate between domestic and foreign consumers. For the domestic supply of natural gas to be available on terms that are internationally competitive, Commonwealth, State and Territory Governments need to cut the regulatory and tax burdens on the domestic gas sector, rather than add to them as AiG has proposed.

The AiG proposal that the Commonwealth Government approve all significant investments in LNG processing capacity would impose costs on the Australian economy but not deliver any benefits.

- It would involve transaction costs that would discourage investment and job creation in the natural gas sector. The most serious of these is the cost of investment delay — in terms of GDP foregone — which could be up to \$5.5 million per day.
- It would encourage ‘rent seeking’ by domestic gas users, environmental NGOs, and local politicians. Any such gains to these groups would be at the expense of the Australian community as a whole.
- The opaque nature of the proposed approval process and the scope for substantial investment delay and rent-seeking would worsen Australia’s sovereign risk and discourage essential foreign investment in LNG processing.

By its nature, the AiG proposal is protectionist. It would inhibit investment, job creation and export expansion in natural gas production in Australia, while encouraging inefficient energy use by domestic users. Its outcomes would be little different to those previously observed with import tariffs.

Adoption of the AiG proposal would put Australia’s international economic relationships at risk by:

- selectively increasing the existing restrictions on foreign investment;
- not complying with Australia’s FTAs with the US and NZ;
- signalling an unwillingness to liberalise foreign investment bilaterally, including when negotiating FTAs; and
- most probably not complying with Australia’s WTO obligations.

The AiG appears to have given little thought to the implications of its proposal for public administration. It is not clear how the assessments against the three tests and the associated public inquiries would be conducted or who would conduct them. These are important issues for public administration for which there are no obvious solutions.