Economic Regulation Authority

Inquiry into Microeconomic Reform in Western Australia

Domestic Gas Reservation Policy

ISSUE

In October 2006, the Government of Western Australia adopted the Western Australian Government Policy on Securing Gas Supplies.

This policy requires a commitment from liquefied natural gas (LNG) proponents to reserve the equivalent of 15 per cent of the LNG production from each export project for the domestic (Western Australian) market.

This is known as the domestic gas reservation policy (DGR policy).

WHAT WE RECOMMENDED

The ERA recommended that the DGR policy be rescinded as soon as is practical.

WHY WE RECOMMENDED THIS

The ERA concluded that there is no economic justification for the government intervention in the domestic gas market.

Government intervention in the domestic gas market may be justified if there is a material market failure.

However, while the ERA observes that the market does not operate perfectly, there is no market failure and therefore no economic justification for government intervention.

Requiring LNG proponents to reserve 15 per cent of production for the domestic (Western Australian) market essentially acts as a tax on the production of LNG. This lowers the returns that can be earned from gas production.

In the long run, less profitable gas production will lead to a reduction in industry investment and cause total supply to fall even further.

The DGR policy distorts the market and prevents Western Australia from realising the full value of its gas reserves.

Artificially diverting gas towards domestic supply will lead to domestic prices falling below those observed on the international market. However, this means that the reservation policy acts a subsidy to domestic users, which is paid for by gas producers.

Low domestic prices result in an overconsumption of gas and will, over time, inhibit innovation in the use of other competing fuels and processes.

It will also result in ongoing investment in infrastructure that is reliant on subsidised gas, perpetuating the need for the subsidy.

The gas reservation policy represents a distortion in the market that prevents Western Australia from realising the full value of its gas reserves.

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BENEFITS OF REFORM

While the DGR policy can be observed to lower domestic gas prices in the short term, the negative effects of the DGR policy over the long term will be particularly damaging.

Repealing the DGR policy will:

- → Help direct investment in industries that have a comparative advantage in Western Australia;
- → Increase the incentives for investing in the gas industry in the long term;
- → Reduce reliance on subsidised gas prices; and
- → Increase the incentives for technological innovation.

COSTS OF REFORM

Rescinding the reservation policy may involve some structural adjustments in the domestic market.

Gas will go to its highest market value use and, in the short term, prices may have to rise beyond the 'export parity' levels to correct for past market anomalies.

Repealing the domestic gas reservation policy will drive innovation, reduce the State's reliance on subsidies, and create incentives for investment.

This fact sheet is part of a series on the ERA's 2014 Inquiry into Microeconomic Reform in Western Australia

The full report and additional fact sheets are available at ***erawa.com.au***

CONTACT US

Contact the Economic Regulation Authority with any questions regarding this inquiry.

CALL
+61 8 6557 7900

EMAIL
records@erawa.com.au

WRITE
PO Box 8469
Perth BC WA 6849