

1 August 2008

Mark Rakers
Mergers & Asset Sales Branch
Australian Competition & Consumer Commission
GPO Box 520
Melbourne Vic 3000
(by email)



Dear Mark

Response to Letter from ACCC re BG, Origin Energy & QGC's Participating Interests

Thank you for your letter of 28 July asking for our views on issues related to BG, Origin Energy and QGC's participating interests in CSM tenements. The attached document sets out our response to your questions. In accordance with your letter, we ask that the attached remain confidential.

We appreciate the opportunity to provide our views on the issues you have raised.

I would like to emphasise again that BG's proposed acquisition of Origin Energy raises issues of significant concern to EUAA members that we urge the ACCC to investigate more fully. These were set out in our original submission.

Please do not hesitate to raise further issues with us in due course.

Yours sincerely

A handwritten signature in black ink, appearing to read "Roman Domanski".

Roman Domanski
Executive Director

Our understanding of the context to your questions

The ACCC are seeking views on the extent to which participating (equity) interests in tenements affect decisions on the production or sale of gas from those tenements. The reason for exploring this is that you are seeking to understand whether, through its participating interest, BG could in future influence QGC (and vice versa) in the production and sale of gas from tenements in which Origin and QGC currently have participating interests. You are also seeking to understand whether the participating interest provides information that could affect the competitiveness of the sale of gas from jointly held tenements.

Why do gas explorers hold tenements jointly?

The commercial rationale for participatory ownership of tenements is that the benefit of supply diversification exceeds the disbenefit of losing unfettered control. Equity participation is common practice in the oil and gas sector where the size of the resource is uncertain, and reducing uncertainty can be expensive. However, such an arrangement can also lead to control that is detrimental to competition.

There is no template for the specification of the rights and obligations of parties to a common tenement. Instead, as with other joint venture arrangements, the rights and obligations are likely to reflect factors such as the historic relationship between the parties, their respective bargaining position, their commercial objectives and so on. In some cases, a simple majority will confer significant control over the development and sale of gas from a field. In other cases, relatively small minorities have significant negative control.

Origin Energy acquired the participating interests in some of the tenements that it shares with QGC, from Pangaea in 2006. Pangaea was, like QGC at the time, an entrepreneurial CSM explorer. We surmise that QGC and Pangaea were in a similar bargaining position, and thus the nature of the rights and obligations in their joint ventures are likely to mean that neither was in a significantly stronger position than the other in negotiating favourable terms.

Can minorities to a shared tenement exert negative control?

In principle, we expect that parties to a shared tenement will generally be able to exert negative control. Moreover, for the participating interest model to be sustainable over the long term, it is likely that parties will seek to cooperate rather than compete. This is borne out in practice. EnergyQuest, experts in the gas industry, has advised us that, in practice, it is highly unusual for parties to exert negative control.

It is also necessary to be mindful of the nature of CSM exploration and production. Unlike natural gas, CSM involves numerous small production wells, rather than a few very large wells as occurs with natural gas. Investment in production infrastructure in CSM can generally be separated from investment in exploration infrastructure. In this case participatory ownership in tenements need not affect the freedom of parties to make their own production decisions.

For these reasons, we suggest that while minorities to tenements have the ability to exert negative control, in practice this may be of limited importance in affecting the ability of parties to tenements to compete with each other for the production and sale of gas. However, as mentioned above, co-operation rather than competition remains a possibility.

It follows from this that Origin Energy's participation with QGC in various tenements did not necessarily affect their willingness to compete with each other. By implication, replacing Origin with BG will, leaving other factors to one side, not necessarily affect their willingness or ability to compete with one another. However, greater co-operation with attendant impacts on competition could be an outcome. The prospects of this could be heightened if the interests of the parties are more strongly aligned – as they could be through the potential to export LNG.

To determine this with more certainty would require a more extensive investigation and access to the sort of information gathering powers that are available to the ACCC under the *Trade Practices Act*.

Does participation in tenements provide information that can affect the willingness or ability of parties to compete?

We suggest that access to information as a result of equity participation in tenements could detrimentally affect competition. The main way that this could arise is through more comprehensive knowledge of the potential capacity of gas resources over a wider geographic area. This is a competitive advantage and can act as a barrier to entry by new explorers, for example.

In the case of QGC, BG and Origin, this issue may be exacerbated by BG's 9.9% equity interest in QGC and its position on QGC's Board. If BG succeeds in acquiring Origin, the BG representative on QGC's Board will have access to confidential commercial information in both BG and Origin. We are not suggesting that the representative would flout his or her Corporations Law obligations. However, it is reasonable to suggest that that representative's access to commercial information from both BG and QGC would put him or her into a stronger position regarding both QGC and BG's interests, but not necessarily in customers' interests. Such action would be consistent with the representative's Corporations Law and fiduciary obligations.

To what extent do Origin Energy and QGC participate in CSM tenements?

We asked EnergyQuest to provide information on the amount of 1P, 2P and 3P reserves in Queensland CSM that is jointly held by Origin Energy and QGC. These data can tell us what proportion of Origin and QGC's total reserves are jointly held.

The results of this analysis are summarized in Table 1 below. The second column is the latest data on total 2P for Origin and QGC (in both cases based on their equity interests). The third column is EnergyQuest data on the amount of 2P reserves in shared tenements. The last column is the quotient of the 2P in shared tenements divided by total 2P reserves (the third column divided by the second column).

Table 1: CSM reserves (2P) in shared tenements for Origin and QGC

	Total 2P reserves (PJ)	2P in shared tenements (PJ)	% of total 2P in shared tenements
QGC	1932	556	29%
Origin	4715	420	9%

Table 1 shows that around a third of QGC's allocated reserves are in fields shared with Origin. For Origin however, the proportion of reserves shared with QGC is very much smaller, at around 10%. It should be noted that both Origin and QGC have not allocated around half of their reserves to specific tenements. It is possible that when such reserves are allocated to specific tenements, the proportion of total 2P reserves in shared tenements is likely to be higher than shown in column 4 of Table 1. EnergyQuest suggested to us that this is particularly likely to be the case for QGC, where a large proportion of its recently announced reserves are in Argyle and Kenya in which it has a shared interest with Origin Energy.

Notwithstanding this, the conclusion from these data is that QGC appears to have a significantly larger proportion of its total reserves in tenements shared with Origin Energy than Origin Energy has in tenements shared with QGC. By this reasoning, any competitive advantage derived from equity participation in tenements is likely to be more significant to QGC than to Origin Energy. We note, however, that Origin's 2P reserves are much larger absolutely than QGC's.

Does equity participation in tenements facilitate joint marketing?

Joint marketing is common in the Australian gas industry, particularly for fields that involve very significant exploration expenditure. The ACCC and its predecessors have authorized several joint marketing arrangements on the basis of its net benefit test.

As part of its joint venture with QGC, BG and QGC announced that they would have a joint marketing agreement. Whether or not such a joint marketing agreement has been formally drafted is not of great significance to the EUAA: through its joint venture with BG, QGC's incentives on the production and sale of gas from QGC's reserves are strongly aligned with BG's interests and so the "joint marketing agreement" may be of little additional value in securing marketing co-operation between BG and QGC.

Nevertheless, such a joint marketing arrangement could formalize and 'tie down' the natural alignment with possible temporal and functional detriments to competition.

In the case of very significant natural gas projects, equity participation in tenements is likely to have a significant role in facilitating joint marketing. However, for CSM, considering the relatively lower capital cost required to achieve production, and the need for numerous small producing wells, rather than a few large wells as is needed for natural gas, participation in the ownership of fields does not necessarily lead to a need for joint production or help facilitate joint marketing.

What conclusions do we draw?

Our analysis leads to the conclusion that whilst QGC and Origin Energy's equity participation in tenements may raise issues for competition this requires closer examination. The following is relevant:

- While the possibility of negative control exists, it is not necessarily the case and whether it could be exercised needs to be considered in more detail.
- However, greater co-operation could result with attendant impacts on competition could be an outcome. The prospects of this could be heightened if the interests of the parties are more strongly aligned – as they could be through the potential to export LNG.
- The publicly available data suggests that a relatively significant proportion of QGC's resources are in shared tenements, while the proportion is much lower for Origin. If there is any benefit to be had from equity participation, this benefit could flow more significantly to QGC than to Origin. We note, however, that Origin's 2P reserves are much larger absolutely than QGC's.
- Taking account of the nature of CSM exploration and production, equity participation in tenements and in exploration need not necessarily make a case for participation in production or joint marketing. However, joint marketing could formalize and 'tie down' the natural alignment with possible temporal and functional detriments to competition.
- One area that may be cause for concern is that through equity participation, parties can gain significant information advantages. This can provide a barrier to entry to new participants. However, since BG is already a participant in these tenements, it would appear that BG's acquisition of Origin could only provide incremental information advantages in respect of these shared tenements if there were some additional advantages that accompanied such an acquisition.
- Only the ACCC has the information gathering powers to determine many of the matters raised more completely.

The EUAA's view is that equity participation in tenements could detrimentally affect the competitiveness of the CSM industry but this is not clear from the information available to us. In other words, if BG's acquisition of Origin Energy is approved and BG therefore replaces Origin Energy as the participant in tenements shared with QGC, this could pose competition concerns but needs to be investigated more thoroughly with the full information gathering powers available to the ACCC.

The critical issue for the EUAA is that BG has already entered into a joint venture with QGC that strongly aligns QGC's interest with BG's. The EUAA suggests that the implication of this is that BG effectively controls the gas owned and produced by QGC. As we set out in our initial submission, this means that if BG's acquisition of Origin Energy is approved, this is likely to mean that BG obtains effective control of 87% of Queensland's 2P CSM reserves.

We appreciate that this relies on a judgment about the incentives that arise from BG's joint venture with QGC. Making judgments on the incentive properties of a contract is more problematic than conclusions on the basis of direct equity ownership. Nevertheless, the EUAA's position is consistent with the theory of contracts, and the empirical observation of what QGC has said and done since agreeing its joint venture with BG. Again, the investigative and information powers of the ACCC would appear to be critical to reaching a firm conclusion.

To reiterate a key point for our initial submission, it is possible that BG always had a strategy to acquire Origin Energy. With the precedent of the ACCC's rejection of Santos' acquisition of QGC in mind, BG may have structured its relationship with QGC as a joint venture and a 9.9% equity interest, rather than simply buying QGC outright as Santos has proposed. The lucrative possibility of exporting its gas through an LNG plant has secured QGC's full co-operation and BG has therefore achieved through contract what it would otherwise have achieved through ownership. By disguising its control through contract, BG may hope to have removed an obstacle to securing the ACCC's approval of its acquisition of Origin Energy. The EUAA strongly suggests that the ACCC should not decide this issue until it has reviewed the details of BG's joint venture with QGC to determine whether the EUAA's concerns are supported by the terms of this joint venture, and QGC's observed actions.

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