

REVIEW OF POLICY RELATING TO THE GRANT AND RENEWAL OF RETENTION LEASES – OPTIONS PAPER

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This paper was drafted by the Department of Resources, Energy and Tourism (the Department) in consultation with the Upstream Petroleum and Geothermal Subcommittee (UPGS) of the Ministerial Council on Mineral and Petroleum Resources (MCMPR). The paper canvasses issues relating to the structure and administration of retention leases under the *Petroleum (Submerged Lands) Act 1967* (PSLA), now the *Offshore Petroleum and Greenhouse Gas Storage Act 2006* (OPGGSA), in the context of the findings of the MCMPR and Ministerial Council on Energy (MCE) Joint Working Group on Natural Gas Supply. In particular, it canvasses options related to how the granting and renewal of retention leases can be improved in a way which would have a positive impact on oil and gas exploration and development in Australia. **The conclusions are tentative only for the purpose of stimulating discussion, and do not reflect the final views of the Commonwealth or other jurisdictions.**

Feedback and comments on any aspect of this paper are welcome, and should be addressed to the Offshore Resources Branch of the Department (contact details below).

1. Scope of Review

On 4 December 2007 the MCMPR and MCE received and subsequently agreed a series of out-of-session recommendations from the Joint Working Group (JWG) on Natural Gas Supply, including that there be further review of policy relating to the grant and renewal of retention leases. The principle recommendation was that:

"The JWG supports further investigation into improving the current acreage management process, in particular the granting and renewal of retention leases to ensure that processes are transparent and that tests of commerciality are rigorously applied and enforced. Proposed changes should be assessed in terms of the degree to which they are likely to have a positive impact on petroleum exploration and production in Australia".

MCMPR/MCE Joint Working Group on Natural Gas Supply – Final Report Sept 2007

The UPGS consists of petroleum regulators from the Commonwealth, States and Territories. The sub committee has provided input to this paper drawing on the JWG and previous reviews on this issue.

This paper is based on a re-evaluation of the submissions provided to the JWG study. UPGS advised industry that this assessment was underway, and welcomed additional input only in the event that industry groups consider they have additional issues to raise specific to the administration of retention leases.

The Department now invites further comment from industry stakeholders. The scope of the review was defined in the JWG recommendation above. The Department understands this to broadly encompass the underlying principles, processes and assessment of retention leases, whether these are still appropriate, and options for policy change.

The purpose of this paper is to facilitate discussion on how the granting and renewal of retention leases can be improved, particularly with regard to transparency of administration and the application of the commerciality test, in a way which would have a positive impact on exploration and development in Australia. The paper seeks to:

1. Describe the original purpose and context for the introduction of retention leases and consider whether these circumstances remain relevant;
2. Investigate the process by which regulators currently assess the grant and renewal of retention leases, and analyse the implications of this for petroleum exploration and development;
3. Investigate how regulators currently assess whether a retention lease is likely to be commercial in the next 15 years (the commerciality test), and analyse the incentives this creates for petroleum exploration and development;
4. Consider options for changing the management of the grant and renewal of retention leases and the implications for petroleum exploration and development; and,
5. Consider options for changing the assessment of commerciality, and analyse the implications for petroleum exploration and development.

1.1 Productivity Commission review of Regulatory Burden on the Upstream Petroleum (Oil and Gas) Sector

In 2008, the Productivity Commission was requested to undertake a research study on the regulation of crude oil and natural gas projects that involve more than one jurisdiction. The study considers Australia's framework for upstream petroleum regulation and considers opportunities for streamlining regulatory approvals, providing clear timeframes and removing duplication between jurisdictions.

In its report released on 30 April 2009, the Commission made a number of recommendations relating to the regulation of the upstream oil and gas industry, including the granting and renewal of retention leases.

In particular, the Commission's recommendation states that –

Recommendation 5.2 - To promote regulatory certainty, governments should clarify and clearly articulate the objective/s and make transparent the criteria and processes used in both approving initial retention leases and renewing existing retention leases. In considering any changes to the retention lease system, governments should:

- *assess the costs and benefits (including the possible effects on incentives to explore for petroleum, and any likely resulting gas supply outcomes)*
- *ensure the costs of intervention are the minimum necessary to achieve the governments' objectives*

- *consider more objective tests of commerciality, such as auction mechanisms, where disagreements about commercial assessments arise, to avoid inadvertent expropriation of exploration investments.*

While the Commission has made this important recommendation on retention leases, this paper examines retention lease issues in greater detail. The Department intends to proceed with the review of the retention lease policy in parallel to the consideration by Government of the Commission's Report and the development of the Government's Energy White Paper.

For further information on the Commission's review, please contact the Productivity Commission directly or view the report at:

<http://www.pc.gov.au/projects/study/upstreampetroleum/report>

1.2 Structure of discussion paper

The paper discusses the management of retention leases, provides history and context, outlines current issues and provides options to address those issues. The issues and options are discussed, followed by draft conclusions.

The options and conclusions in this paper acknowledge the unique issues related to commercialising large offshore gas fields which are suited to development as LNG projects and posit potential means to facilitate their development for consideration by UPGS. It is important that any regulatory changes to facilitate commercialisation of these fields also take into account the potential or unforeseen effects on titles held over fields which are better suited to development as domestic gas projects and on titles which are held over potential oil projects.

The Department invites comment on the options and conclusions contained in this paper or welcomes alternative positions to be put forward by industry.

2. Retention Leases – Origin and Purpose

Regulatory Background

Retention leases were introduced into Australian offshore waters by 1985 amendments to the *Petroleum (Submerged Lands) Act 1967*. The purpose was described as to:

"provide for the granting of retention leases over currently non-commercial discoveries. Retention leases will allow explorers to retain tenure over discoveries until they become commercial and should provide an additional measure of encouragement for companies exploring in deep water or gas prone areas"¹.

While the explanatory memorandum does not provide full detail for the specific lease design, the intent of the amendment was to provide encouragement for companies exploring in deep water or in gas prone areas but not to quarantine large areas containing

¹ The *Petroleum (Submerged Lands) Amendment Bill 1985*

commercially insignificant discoveries. It is clear that the economic difficulties of bringing deeper water oil and gas to market were recognised as requiring longer timeframes to realise returns on exploration and development investments.

Retention leases had to satisfy two criteria:

1. the discovery was not, at the time of application, commercially viable, and
2. the discovery was likely to become commercially viable within 15 years.

The term of a retention lease was for 5 years with the commercial development timeframe of 15 years presumably established to allow a reasonable opportunity to commercialise the discovery while ensuring that the area would eventually be made available again for exploration should commercialisation be unsuccessful in that time. There was no limit imposed on the number of renewals which in practice provided no maximum period for retention leases subject to meeting the commerciality test. The test of commerciality was not specifically defined.

The amendments also noted that titleholders would maintain an active commitment in this area, undertaking a work program, field work, evaluation and marketing, or commercial studies which would address the barriers to commercialisation for the duration of the title. It is clear the overriding intent was that the titleholder should pursue the objective of bringing fields into commercial development in the minimum possible timeframe.

In the *Offshore Petroleum and Greenhouse Gas Storage Act 2006*, the application has to satisfy principally the same two criteria:

1. the discovery is not commercially viable at the time of application, and
2. is likely to be commercially viable within 15 years from when the application is submitted.

The term of retention leases is 5 years and there is no limit on the number of renewals that can be applied for, as long as these two criteria continue to be met. There remains no clear definition of the term “commercially viable” although the Retention Lease Guidelines do give some guidance on how the term should be interpreted.

If an application for the grant of a retention lease is refused because the recovery of the petroleum is found to be commercially viable, the titleholder has until the exploration permit expires to apply for a production licence.

If an application for the renewal of a retention lease is refused because the recovery of the petroleum is found to be commercially viable, the titleholder has 12 months to apply for a production licence. A production licence is issued for the life of the field but the Joint Authority (JA) may terminate the licence if no petroleum recovery operations have been carried out (or commenced) for a continuous period of at least five years but is not obliged to do so. The titleholder can apply for a retention lease within five years of the grant of a production licence or within five years of the cessation of petroleum recovery operations.

While outside the scope of this paper, there may also be a requirement to review the use of the JA's "may" power in relation to the cancellation of production licences. In order to improve transparency and certainty it may be appropriate to provide clear interpretation of the circumstances in which a production licence may be cancelled. It should be noted that it is unlikely that genuine efforts to develop would result in the discretion to cancel being exercised.

Statistical background

Since 1985, a total of 58 retention leases have been granted. Of these:

- 28 are in their first terms or before the JA for renewal;
- 4 have been renewed once;
- 13 have been renewed twice;
- 10 have become production licences;
- 2 were refused renewal; and,
- 1 has been surrendered.

located as follows:

- 6 in the Territory of Ashmore-Cartier Islands;
- 3 offshore from the Northern Territory;
- 1 offshore from Tasmania (the Yolla field is partly covered by a production licence, partly by a retention lease);
- 4 offshore from Victoria; and,
- 32 offshore from Western Australia (3 in the Bonaparte Basin, 5 in the Browse Basin, 24 in the Carnarvon Basin).

Of these, 37 are predominantly gas fields (most of which are associated with varying levels of condensate reserves), 6 are predominantly oil fields, and 3 contain both oil and gas. Since 1985, 10 retention leases have been converted to production licences as the fields have become commercial. Six of the retention leases were offshore from Victoria, 2 offshore from WA, 1 offshore from Tasmania and 1 in the Territory of Ashmore and Cartier Islands. The majority of the 10 fields were associated with oil or combined oil and gas reserves (8) with only the Kipper and Minerva gas developments in Victoria being solely gas developments.

Seventy per cent of retention leases are offshore from Western Australia and 80 per cent of retention leases are held over gas fields. Almost 50 per cent of the retention leases are associated with potential large LNG projects. That the majority of retention leases is held over gas reserves reflects the unique issues associated with commercialising gas resources remote from both infrastructure and markets.

Changing context

The commercial environment for offshore petroleum in 1985 was significantly different to that we currently experience. In 1985 crude oil prices were approximately US\$26 per barrel, dropping in the subsequent 4 years to an average of US\$16. The new frontier of

the Australian offshore petroleum industry was the Carnarvon Basin where explorers were hoping to find a second, oil-rich Bass Strait. Instead, the discovery of large reserves of gas in relatively deep water, remote from both markets and infrastructure provided a major challenge for the industry to monetise these resources.

The LNG industry was 25 years old, technology costs were coming down, market interest was growing – particularly in Japan – and the industry was becoming known as the solution to commercial development of remote gas fields such as those in Australia's north west.

Domestic gas production had commenced from the first stage of the North West Shelf Project in 1984, underpinned by a long-term, take-or-pay domestic gas contract with the Western Australian Government. This infrastructure investment provided confidence for Japanese LNG customers to sign contracts with the North West Shelf Project in 1985, allowing the second stage of development to proceed, culminating in Australia's first LNG shipment to Japan in 1989.

The unique challenge of commercially developing Australia's large remote gas reserves was the major driver leading to the introduction of retention leases in 1985.

However the underlying circumstances today are more favourable than in 1985 to commercialise Australia's remote gas fields for the following reasons:

- Third party infrastructure – production facilities, pipelines, utilities such as power and water, logistics and supply facilities – is more extensive in some areas, particularly for the Carnarvon Basin offshore from Western Australia;
- Industrial sites have been set aside for additional gas processing and downstream industries in various States and the Northern Territory;
- Technology has advanced to the point where water depth and remoteness are less problematic, both in technical and economic terms;
- Domestic markets are growing with more proposals for major industrial projects such as power generation, fertilisers, minerals processing, gas to liquids and gas chemicals being considered; and,
- LNG markets are growing with a global move to cleaner fuels, the opening of the China market and the future potential of India, and a good long-term outlook for established Japanese, Korean and Taiwanese markets.

In the short-term, Australia's gas developers face the challenges of the economic slow-down arising from the global financial crisis coupled with more supply competition from Qatar, Indonesia, Russia, Yemen and Nigeria, and potentially more coming from Algeria, Angola, Peru, Libya and others.

There remain challenges unique to Australia. Many of Australia's international competitors in the LNG industry have benefited considerably from the direct ownership or investment policies of host governments. Investment timelines are often driven by national oil and gas companies which have a stake in some 80 per cent of the world's LNG production. With national governments as major project shareholders, the lines are blurred between market drivers and the policy and fiscal drivers of the national government.

However, the Australian Government recognises that the key driver of our resource development must remain the operation of an efficient and transparent market. The Productivity Commission has noted that our policies and legislative framework must not impede or delay the commercial development of Australia's offshore gas resources but should be enabling the earliest possible development of Australia's offshore gas resources.

Australia's regulatory framework was designed in an era of smaller-scale oil and gas projects and less complex markets, both domestically and internationally. For example, multi-train LNG developments could require more than 20 trillion cubic feet of gas and therefore there is a need to recognise that a number of gas fields may need to be set aside for sequential development over the 30 or 40 year life of a project. There is also a need, however, to ensure that any policy changes do not lead to warehousing, particularly when domestic gas customers or existing LNG infrastructure owners could provide commercial options for earlier development.

The challenge for Government is to get the balance right. For example, it is not in Australia's interests to strand gas resources indefinitely, particularly when there are potential economic markets. Nor would it be appropriate or efficient to undermine sunk investments in LNG and domestic gas infrastructure that still have major economic potential. Equally, the policy framework must promote, rather than impede, greenfield investments in LNG when they are in the best interests of gas developers and the nation. And, importantly, Government must strike the balance between attracting and protecting investment in exploration while also delivering development outcomes.

Retention lease policy is one factor that needs to be considered in dealing with this challenge. Other matters of policy and regulation must also be considered. This is currently under way through the development of the Australian Government's Energy White Paper, the Australia's Future Tax System Review, and the response to the Productivity Commission's Review of the Regulatory Burden on the Upstream Petroleum (Oil and Gas) Sector.

Issues

Concerns have been raised that the sharp rise in the volume of gas held under retention leases indicates that the orderly progress from exploration to development of gas resources is not occurring. Particularly, it could be argued that the retention lease system might allow companies to avoid pursuing development opportunities other than vertically integrated LNG projects. There is extremely limited activity in the third party gas market which would encourage the further development of existing LNG hubs and limited engagement with domestic gas customers by large gas holders pursuing LNG developments.

Historically in Australia, most domestic gas market engagement was driven by government policies such as domestic gas reservation, mandated levels of gas use for specific purposes such as power generation, conditions in State Agreement Acts or other project approval instruments.

Retention leases may open the possibility of warehousing commercial discoveries and potentially removing the incentive to respond to improved project economics as a result

of changing market circumstances or the development of nearby supporting infrastructure. Conversely, retention leases could also prevent the assembly of a critical mass of reserves to underpin a major project.

Options

- Status quo – no change to retention leases is required;
- Abolition of retention leases; and,
- Modification of the parameters and administration of retention leases.

Discussion

The commercial environment for offshore development has changed significantly from when retention leases were first implemented, and the rapid proliferation of retention leases at a time of unfulfilled domestic demand and increasing numbers of longer-term LNG customers suggests a *prima facie* case for changes to the status quo.

Abolition of retention leases would force the lessee to develop the acreage, sell it to a developer, or lose the title. In the case of a surrendered title, the vacated acreage could be reallocated, either by work tender or auction, to others more likely to move to production. This would have a major impact on Australia's investment risk profile for exploration and could also force inefficient development before an area is properly appraised or marketing and commercial matters satisfactorily concluded. It would also raise difficult issues about access by third parties to the sensitive commercial information of the leaseholder – without which there would be considerable uncertainty about whether development could be progressed.

Despite the rapid development of the offshore gas industry, and the growth in oil and gas prices experienced since 1999, the rationale for some form of protection of title over sub-commercial resources remains. Deep water frontiers are still relatively under-explored and more remote discoveries may well be challenging to develop. In these situations, the retention lease system provides a mechanism to attract investment to frontier areas by offering the opportunity to hold a resource for a period of time until project economics are favourable.

While there is some connection between retention leases and strategic domestic gas supply issues in that retention leases should be refused where commercial domestic gas opportunities exist, there is no guarantee the removal of retention leases would increase domestic gas supply *per se*. Having no retention leases would be akin to the current situation when a retention lease application is rejected – development is required but commercial considerations determine the ultimate development and market for the project.

Although retention leases may be justified, the change in context from when they were first introduced provides a *prima facie* justification for reviewing their management and key parameters. As the most drastic changes have taken place in the commercial environment for gas, it is perhaps reasonable that the key parameters for assessing commerciality be given further consideration.

For example, consideration should be given to whether the "15 years" criteria puts sufficient pressure on companies to move to development, or whether this should be shortened or otherwise fixed relative to the time from when the retention lease is first granted². While major Australian gas projects have historically required long lead times to get to final investment decision, the Pluto project has set a new global benchmark and is expected, when operational by the end of 2010, to have proceeded from discovery to LNG production in just five and a half years.

Consideration should also be given to definition and application of the commerciality test. Currently, commercial assessment is primarily undertaken on development proposals most favoured by the leaseholder. There is little focus on development alternatives and generally limited assessment of options not proposed by the leaseholder.

There may be insufficient pressure in the retention lease process to ensure all participants in a joint venture are aligned with the objective of the Government to monetise resources at the earliest possible time. Consideration should be given to measures that would guard against one or more joint venture participants holding up investment decisions or taking strategic positions which serve to delay development. This could be achieved by placing the onus on the leaseholder to apply for a production licence if at any time a field becomes commercial, rather than preparing one assessment of commerciality at the end of each retention lease term. Another option would be to provide the ability for significant equity holders in a lease to progress a commercial development irrespective of joint venture arrangements. A rigorous examination of work programs prior to grant of retention lease (or of renewal) may be considered, with obligations for each annual period rather than the RL term, to encourage more timely commercialisation and commitment of leaseholders.

Draft conclusions

- 2.1 Retention leases play a necessary role in the efficient development of Australia's offshore resources, and therefore should be retained.
- 2.2 Some form of assessment of commerciality is essential to the lease award, but the definition and application is essentially arbitrary. This suggests the need for further review of these parameters, including an analysis of alternative systems used in state jurisdictions and elsewhere around the world.
- 2.3 Measures that more clearly implement the Government's objective to develop resources as early as commercially possible should be considered.
- 2.4 Any changes to the risk/reward balance should be consistent with the direction of other policies designed to encourage investment.

3. Administration of Retention Leases

Background

The current administration of retention leases has been described in a series of previous papers to the MCMR and UPGS. In essence, an exploration permit holder can apply for

² That is, the timer of the 15 years could start running from the issuing of the first retention lease, and would not be "reset" at each renewal. The danger is, of course, of one arbitrary number being replaced with another.

a retention lease after declaring a location over a petroleum discovery. Retention leases are issued for five years, and can be renewed. At the time of application for a grant or renewal of a lease, the applicant must demonstrate that the resource is not commercially viable at the time of application, but is likely to become commercially viable within the next 15 years.

A production licensee may also apply for a retention lease where the resource is no longer commercially viable, for instance where a field becomes uneconomic, due to increased costs or decreased returns, but has the potential to revert to commercial status at a later time.

At any time during the five year term of a retention lease the Government can request a review of the commercial viability of the field in the lease area. An amendment to the *Petroleum (Submerged Lands) Act 1967* in 2002 limited the number of "commerciality reviews" to one per term (from two per term). A leaseholder must respond within 90 days (or such period as the JA allows) when requested to re-evaluate commercial viability of the lease area. This provides an opportunity to prevent the leaseholder from warehousing a resource when it may have become commercially viable to develop, for example through changed market conditions, technological developments or infrastructure availability.

The detailed requirements of a retention lease application, and information on how this is assessed, is contained in the *RET Offshore Petroleum Guideline for Grant and Administration of a Retention Lease* (June 2006).

Government regulators undertake an assessment of applications against criteria in the OPGGSA and in the Retention Lease Guidelines. The assessment includes examining whether the field is commercially viable at the time of application, and whether it is likely to become commercially viable within 15 years. An assessment report is written jointly by regulators from the Commonwealth and the Designated Authority covering technical and commercial factors in relation to the application. This report then provides the basis for recommendation to the relevant Ministers, or their delegates, in the Joint Authority (JA).

3.1 Applications for Grant and Renewal

Background

According to the 2006 guidelines, an application for a retention lease under Section 141 requires, amongst other things:

- identification of all realistic development options for the resource;
- evidence that development is not currently commercially viable, but is likely to become commercially viable within 15 years, spanning the technical, cost and economic assumptions used, including:
 - estimated recoverable and in-situ resources;
 - estimated annual capital costs, including appraisal and production drilling, facilities costs etc;
 - estimated annual operating costs;

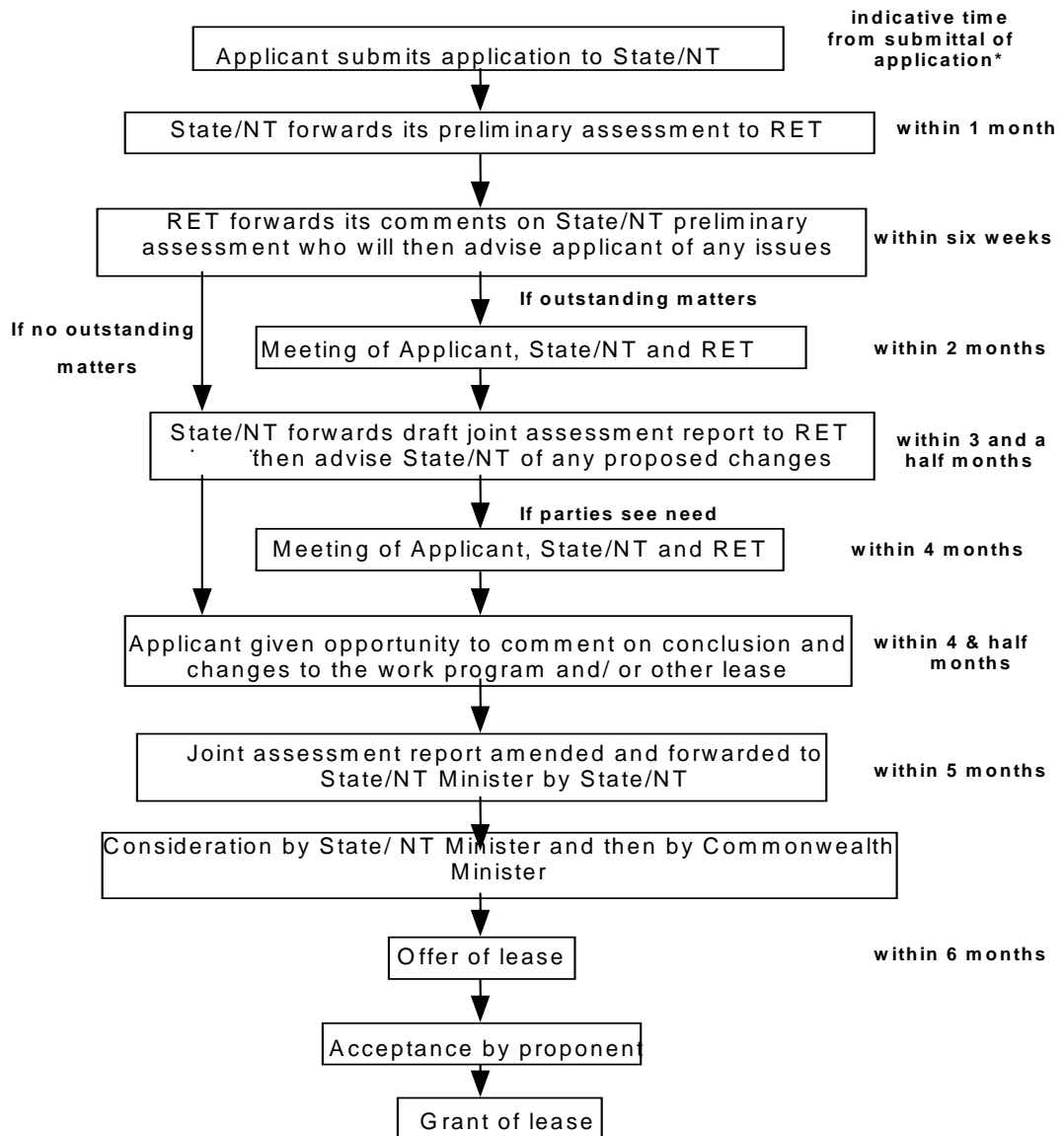
- estimated annual production volumes, product prices and estimated annual revenues from sales of product;
- estimated annual resource taxation payable;
- inflation rates, exchange rates, bond rates, depreciation and company tax provisions used in the analyses;
- estimated pre and post company tax internal rate of return for the project; and
- identification of the circumstances which would make the resource commercial, and the likelihood of this occurring.

Assessment of the application is in accordance with the 2006 guidelines and the October 2007 Guidance Note. This is often an iterative process between the applicant and the DA and the Commonwealth, designed to clarify elements of the submission and to determine whether assertions by the applicant are justified (Figure 1).

The applicant also proposes a work program, which is assessed for its adequacy to address barriers to commerciality. The JA's analysis of the application and these issues is compiled into a detailed Joint Technical Report (JTR), which is the basis for the decision by the JA on the application. The JTR is drafted jointly by the DA and the Department, with advice provided by Geoscience Australia.

As the commerciality test is a crucial element of this decision, the guidelines provide details on the types of information required by the application to reasonably establish the size of the marketable resource and the economics of the project. This includes information required to establish the likely financial viability (e.g. to support internal rate or return calculations) of all realistic development options.

RETENTION LEASE APPROVAL PROCESS



* Indicative times may reduce where stages are skipped

Since 1999, for administrative efficiency, State and Commonwealth Ministers have delegated all JA and DA powers to officials. Since early 2008 these delegations have been subject to the following conditions:

- JA Ministers having the opportunity to issue media statements when important decisions are made, such as the award of offshore petroleum titles;
- any contentious or strategic issues being referred to Ministers (such as decisions that deviate from approved policy or well established precedents, or where there is a difference of opinion between Commonwealth and State/Territory officials); and,
- Departments are to report regularly to their respective Minister on decisions envisaged in a coming period, report back on delegated decisions taken during the previous period and provide timely advice on issues arising from delegated decisions that might affect Ministerial accountability.

These conditions have been agreed by all MCMPR Ministers.

It is estimated that a quarter of decisions have been elevated to ministerial level in the last nine years. The elevation is to ensure appropriate ministerial oversight of "non-routine" matters, but does not change the assessment criteria or notably alter the process from the applicant's perspective.

There is no public consultation process with respect to retention lease applications, although there are increasing third party concerns about retention lease approvals and renewals, particularly from major domestic gas customers.

Issues

For both the certainty for industry and ease of assessment, it is important that guidelines accurately reflect the process and assessment criteria.

The guidelines outline protocols and timelines for the approval of retention lease applications, envisaging a six month process from the time of application to the offer of a lease. However, the process is complex, it involves the interaction of at least three parties and there is considerable scope for differences of interpretation around geological data and commerciality issues. Providing shorter and more predictable approval timeframes should assist in finalising exploration and development investment decisions while improving transparency and certainty for the companies involved in the process.

A number of submissions to the JWG study identified the need to consider strategic aspects of domestic gas supply in the consideration of applications. While this is arguably outside the assessment criteria, it may be an area where specific ministerial level assessment of the national interest is appropriate.

Given that marketing practices for both LNG and domestic gas (joint vs several) have changed over time since introduction of retention leases as a title in 1985, consideration should be given to a requirement by all leaseholders to demonstrate reasonable efforts to secure commercial markets.

The complexity of the industry today has also increased and it may be that independent expert advice relating to technical and commercial matters could be required to assist decision-makers in some instances.

Options

- Status quo;
- Revise guidelines and amend approvals timeframes to ensure greater transparency and certainty for industry and greater clarity regarding the objectives of the Australian Government;
- Streamline administrative processes;
- Make decisions subject to the DA or Commonwealth only; and,
- Widen the scope of retention leases which are elevated for ministerial consideration.

Discussion

The granting of retention leases is a major decision in the management of the offshore area by the JA. The different jurisdictions often have differing perspectives, which can

enhance the rigour of the assessment process, but can also be problematic in terms of approvals timeframes and the consistent and proper implementation of the Commonwealth's overriding objective to achieve the timely and efficient development of Australia's oil and gas resources.

The application formats and guidelines appear to be reasonably well understood and established, and the Commonwealth and State/Territory officials continually work towards consistency in applications and in the JTR format although issues of transparency, timeliness and consistency remain. However, there are opportunities for improvements to the Retention Lease Guidelines:

- to fully reflect the Commonwealth's objectives;
- for independent technical and economic review; and,
- for greater transparency and accountability.

The Productivity Commission in its report has recommended the establishment of a single national offshore regulator for Commonwealth waters as a means to achieving these improvements. The Commission has argued that this would lead to a more effective and efficient system for the regulation of the industry. The Government will be considering this recommendation as part of its overall response to the Commission's report.

Draft conclusions

- 3.1 Consider current approvals take too long and recommend investigating ways of streamlining approvals processes.
- 3.2 Recommend that the guidelines be updated to reflect current practice and reviewed to determine whether they are properly implementing the Commonwealth's policy objectives and providing sufficient certainty to industry about the application and assessment process.
- 3.3 Recommend the criteria determining which retention leases are referred to ministers be updated, including adding an explicit reference to referring leases of strategic significance.
- 3.4 Note the recommendation of the Productivity Commission in relation to the establishment of a single offshore regulator which will be considered as part of the Commonwealth response to that report.

3.2 Conditions imposed on Retention Leases

Background

The OPGGSA allows for retention leases to be subject to conditions (s136) as the JA sees fit, including conditions in relation to work to be carried out in a lease area, or amounts to be expended, or both. The guidelines require an applicant for a retention lease to submit a proposed work program for the lease area which, if acceptable, would be included as a condition of title.

The guidelines note that "...as one aim of a retention lease is to ensure the holders of the lease actively seek to enhance the commerciality of the relevant discovery, government

will assess whether the applicant's proposed work program ... is adequate".³ There is an exception "in certain cases where the reason for lack of immediate commerciality is outside the power of the lessee (e.g. related to the commodity price) and there is little scope for proving up additional potentially commercial resources within the lease area, there may be no justification for any work program commitment, or the program may not involve any activity to be undertaken other than, for example, studies to reduce costs."⁴

The guidelines clarify that the work program should address the primary constraints to commercial viability defined in the assessment, address other important areas where base information is lacking, and should be consistent (with regard to timing, the activities proposed and the level of effort) with what a reasonable company could be expected to carry out in order to commercialise the project.

In practice the work programs vary widely, from conditions to spend \$20,000 per year on "studies" to more specific programs of exploration/appraisal and marketing and engineering studies.

Work programs are typically volunteered by the company and assessed as being adequate or otherwise. The JTR usually includes some brief observation on whether the proposed work program is an appropriate basis for the work in the upcoming years.

At some point the JA is required to assess whether conditions have been met. Under the guidelines, it is a condition of renewal of a retention lease that the applicant has met all the conditions included in a previous retention lease⁵.

Issues

For work program conditions to be enforceable they need to be included in the title document⁶. This would allow scope for penalties and enforcement measures to ensure that the required work is carried out. At present, this appears to be the exception rather than the rule, and those programs specified are rarely as closely administered as might happen with an exploration permit. For example, some titles will specify the conditions as work to be carried out in a particular year, others will provide a range of years, some will require expenditure and in some the expenditure appears indicative. Without clear specification it is questionable as to what extent these conditions are enforceable⁷.

A danger of a poorly specified work program is that the title may be inactive, or that it may not address the barriers to commerciality in a timely fashion, making it more difficult to make a clear assessment of commerciality. For example, a title area may be close to infrastructure with idle capacity, but it is difficult to argue issues of commerciality if there have been no genuine discussions on access to this infrastructure in advance of the application being assessed. Similarly, while a title area may be earmarked as a component of a future LNG development by the titleholder, it is difficult

³ Guidelines, 7.3

⁴ Guidelines, 7.4

⁵ Guidelines, 11.2

⁶ Or a specific Direction, although these seem to be rare and there is little specific to RLs in the standard schedule of directions.

⁷ A related issue to clearer conditions might be a requirement to also specify on what basis these conditions might be suspended or varied, as in the case of exploration permits.

to argue issues of commerciality if there have been no genuine discussions on potential domestic gas market development or other options in advance of the application being assessed.

Unless the leaseholder is undertaking a physical offshore operation, the reporting requirements for a retention lease appear less onerous than those for an equivalent exploration permit. In many cases there would appear to be only a requirement for an annual report⁸. An exception might be if there was an established Data Management Plan⁹, but there seem to be no examples of these being used in the case of retention leases. The Commonwealth (RET and GA) have only irregular examples of annual reports and no set process for monitoring compliance. It is not clear if this is done by the DA.

When considering the work program, the applicant may be focussed on the commercialisation of a particular pool, rather than exploration in other parts of the lease area. The JA many need to have regard to exploration of targets beyond the main petroleum pool.

In addition, where there are multiple leaseholders to a lease there is a process involving each leaseholder which leads to proposal of a work program. This can lead to a "lowest common denominator" approach to the formulation of work programs. This approach may not be consistent with the Australian Government's objective to minimise timelines to commercial development. It may be appropriate to invite each leaseholder to submit a proposed work program for consideration.

Options

- Avoid placing conditions on titles;
- Require a structured program of work towards commercialisation;
- Ensure conditions are enforceable;
- Implement greater monitoring of performance against conditions;
- Clarification of penalties for breach of title conditions;
- Make title conditions time-bound within the 5 year RL period; and,
- Require all market opportunities to be fully and properly progressed and commercially assessed until firm (eg key terms agreements) market options are established.

Discussion

Given that retention leases are not intended to be "inactive", and that if a titleholder does no work to advance commerciality in the lease period it is likely that the lease will fail commerciality tests at the next renewal, there seems some logic to reasonable conditions being placed on titles. A first step might be rigorous assessment of whether work programs proposed by titleholders are structured in a way which logically progresses commerciality and, if so, whether these are appropriate title conditions.

⁸ Reg 304 of the PSLA Data Management Regulations seeks reports "related to the carrying out of a work program" before the end of each title year.

⁹ DMPs are under review, but even if discontinued the general principle of reporting to an agreed standard would remain relevant.

Some judgement is needed here, as some leases may be limited in commerciality by factors outside the titleholder's control, but many titles clearly require field or commercial work if they are to progress to development.

It also follows that any work (field or commercial) would have a minimum schedule to work towards, so that the titleholders work logically and consistently towards addressing commerciality constraints *before* they lodge their next renewal application. In that sense, the precedent of the exploration permit work program may be a useful and well understood model to adapt in the case of retention leases.

Assessing the conduct of commercial negotiations both between leaseholders and also externally with potential customers is inherently difficult, particularly the issue of whether negotiations are being undertaken in good faith. Nevertheless, it may be possible to get some evidence of discussions – records of meetings, key correspondence – to be able to provide some proof of constructive engagement. The burden of proof would remain on companies to demonstrate that they have fully tested the market and explored all possible development options in good faith.

If it is deemed that conditions are reasonable, it follows that these conditions should be written in a framework which is enforceable and systems are in place to monitor performance. The JA would also have to give further consideration to penalties for the breach of conditions of title.

Draft conclusions

- 3.5 Recognise the important role that reasonable title conditions can play in ensuring retention lease holders actively address barriers to commercialisation of a discovery;
- 3.6 Recommend that assessment conditions should include a reasonable program of work (field and commercial), similar to those which apply to exploration permits. The program would be derived in the first instance from an assessment of the merits of the program proposed by the applicant;
- 3.7 Recommend title conditions should be clearly specified in the title document in terms of work and the year or years in which it will be carried out. The description should be sufficient for the DA to be able to determine if this work is done without reference to the application document. There should be uniform practices between jurisdictions;
- 3.8 Recommend the reporting requirements for retention leases be clarified, and be sufficient to enable monitoring of work programs. For example, study elements should be clearly specified and reports on commercial discussions should provide sufficient evidence for the JA to determine that these have been carried out in good faith and in a timely manner;
- 3.9 Recommend these reports be provided to both the DA and the Commonwealth and an assessment made as to whether the leaseholder is meeting its title conditions;
- 3.10 Recognise cancellation as a legitimate option if lease conditions have not been met; and,
- 3.11 Support the consideration of methods by which evidence of progress in work programs can be tested or validated effectively.

4. Transparency

Background

The application process and even the award of titles is relatively opaque. In as much as greater transparency at the application phase may give rise to information which is relevant to the JA's assessment of commerciality, this matter should be given further consideration.

Title documents are searchable instruments on the petroleum register, but sourcing the actual document may not give a great deal of detail on the program. The award of retention leases and locations are published in the relevant Government Gazette. A standard Gazettal notice describes the "Notice of Grant of retention lease for Petroleum Permit XX". The information is limited to the titleholders, term (five years from a specified date), and the graticular block reference. There are no maps and they are published in a number of different gazettes depending on which DA is responsible. Locations are also gazetted with similar (lack of) detail. This is consistent with exploration permit gazettals, which have no work programs specified and are accompanied by varying details of location specification.

The full contents of applications and the JTRs are not made public, due to their tendency to include commercially sensitive information¹⁰. It would seem unreasonable to move to release the level of detail in the JTR, as this could compromise willingness of companies to answer questions and may adversely affect their commercial interests.

Issues

This lack of transparency has the potential to give rise to criticism that retention leases are inactive. It is also the case that the JA may miss out on information relevant to a decision from a third party (discussed further in section 5.4 below). However, many aspects of the application are commercially sensitive, and care should be given to protecting the intellectual property of investors.

Options

- Status quo – basic public information provided through gazettal notices and searchable registers;
- All applications be made public;
- A subset of information, similar to an executive summary, be made public; and,
- A statement of reasons for decision, be made public.

¹⁰ Consistent with the treatment of Protected Confidential Information under the P(SL)A Data Management Regulations 2004, or "documentary information [classified] as a trade secret, or something which could reasonably be expected to, adversely affect the person in relation to the person's lawful business, commercial or financial affairs" (Reg 5). Information may also be considered "protected derivative information" if the lessee or the DA view that the information or an opinion is a "conclusion drawn wholly or partly from, other documentary information. (Reg 6). The latter may be released after five years, or both types may be release earlier with the agreement of the titleholder.

Discussion

Major changes to the OPGGSA would be required before applications could be made public in their entirety, and there would be a significant cost in terms of investor risk. However, there may be elements of the applications which can be reasonably made public. For example, in the application assessment process the Department does circulate elements of the retention lease application (usually basic title information and maps) to stakeholders in AMSA, AFMA, Defence, Reach (undersea telecommunications cables), NTT/ATSIC for comment. There is therefore an understanding that some basic elements of the application can be made available outside the JA to other government agencies.

Gazettal and the register do provide a formal record of retention lease decisions which, while public, are not very accessible sources of information by modern standards. There are a number of possible models for this, from the minimal information the JA publishes in media releases related to exploration permits, to the more detailed referral documents of the *Environment Protection and Biodiversity Conservation Act*.

Draft conclusions

- 4.1 Support the need to protect commercially sensitive information within a retention lease application.
- 4.2 See benefit in greater transparency of retention leases, and proposes summary information drafted by the applicant be published (typically on the internet) about upcoming applications, titleholders, terms, title conditions and barriers to commercial viability. The information should be sufficient for third parties to establish the relevance of the lease application, akin to an executive summary, without containing commercially sensitive information.

5. Commerciality Tests

Background

The current guidelines note the assessment of commerciality as the most important aspect of determining the outcome of a lease application. 'Likely' is defined as "substantial or real chance as distinct from what is a mere possibility", and 'commercially viable' is interpreted to mean that the petroleum could be developed,

- (a) Given existing knowledge of the field;
- (b) Having regard to prevailing market conditions; and
- (c) Using proven technology readily available within the industry;

such that the commercial rates of return from recovery of the petroleum (including recovery of all operating and capital costs and taxes, royalties and other charges) meet or exceed the minimum return considered acceptable for the type of project under consideration by a reasonable petroleum developer and by investors or lenders to the industry (i.e. an acceptable rate of return). Existing knowledge of the field includes mapping and resource estimates at proved, probable and possible probability levels."¹¹

¹¹ Guidelines, 5.2

Importantly, the guidelines also specify that "a petroleum accumulation cannot be claimed to be *not commercially viable* because of the inability or unwillingness of the titleholder to acquire or apply proven technology readily available within the industry or because of the applicant's lack of skilled personnel or financial capability".

The guidelines also reflect the JA's understanding that "the market for natural gas is often characterised by large, long term contracts, at specified rates over specified periods, and specific quality. Therefore in some circumstances, the JA may agree that an otherwise commercially viable gas project may not proceed due to an inability to obtain a contract which would support development. In recognition that market considerations can stall an otherwise commercially viable 'dry' gas project, the JA will give favourable consideration to an application for a lease if the leaseholders with marketing responsibilities, can demonstrate reasonable attempts in good faith to obtain gas supply contracts which were unsuccessful. In such a case, the major test in assessing whether the criteria have been met is likely to be assessing the leaseholders' efforts in obtaining a market for gas.

There is not an explicit requirement to specifically examine a domestic gas option, but it is explicit that "all realistic options" should be considered¹², and this would include the commercialisation of a field to supply the domestic market. It would also include the commercialisation of a field to develop through third party infrastructure where that was a potentially viable option.

5.1 Treatment of Commerciality in Applications

Background

Drawing on the guidelines, applications for retention leases are generally comprehensive documents which attempt to address all aspects of these criteria in some detail.

Applicants generally present a range of options for commercialisation in their applications, but with an emphasis on the preferred development option. This generally includes some evaluation of a domestic gas marketing option, and companies are required to submit financial data, but the starting premise varies. For example, from three different applications:

- "At present there has been no gas sales contract signed for the field's gas. Until such a contract is secured with an adequate gas price and conditions, the field cannot be considered economically viable".
- "Commercial viability – the field is presently judged to be uneconomic, because of the lack of infrastructure in the area and the relatively low gas prices".
- "To successfully market the field's gas two requirements need to be satisfied. The first is a price outlook sufficient to make the development economic. The second is a secure, long term supply agreement to underpin the development".

In all the above examples the applicants provided additional supporting data, including discounted cash flows to support their claims. Indeed, it serves the applicants to be not

¹² Guidelines, p15

too pessimistic about these market options as the need to satisfy the "likely to be commercial in 15 years" criteria. However, it is arguable that these applications do not specifically provide evidence of "reasonable attempts" to secure a *domestic* gas contract or engage with third party infrastructure owners. It often appears that the starting point is that the gas is not marketable.

It is also apparent from applications that pricing alone is not the sole criteria for a contract, and that volume and timing are key variables in determining a workable price outcome for supply.

It is also the relative profitability of domestic gas (i.e. net of costs and relative to LNG), rather than its price per se, which determines if domestic gas supply is a viable option. It is likely that if domestic gas prices do not approach LNG net-back prices, then no gas will go onshore if there is an LNG alternative. The relevant domestic prices are not the extremes currently being set for short-run or boutique supply, but those which can be locked in over a longer (say 10 year) period. Long term contracting is sometimes difficult in what is currently a thin and volatile market.

The market opportunities are considered by the JA in evaluating the application, and the analysis is agreed between the Commonwealth and the DA in the context of the JTR. This includes an evaluation of the IRR and NPV of various domestic gas and LNG options over a range of gas prices, and a clarification of some of the assumptions used in the economic modelling. The company's data is drawn upon heavily in this analysis, but the manipulation is undertaken independently which gives some check on gross error. There are generally a range of discount rates used and the JA makes a judgement as to whether the applicant has addressed the different cash flow scenarios using appropriate discount rates and oil prices. There is some assessment of whether the assumptions in the models (including costs and exchange rate choices) and likely hurdle rates of return are accurate and realistic.

There is potential for companies to slow the application process by limiting the scope of the application, and not volunteering some information until a specific request is made. The process of the JA requesting additional information can significantly delay the assessment process, often to the company's advantage.

There are only limited examples of the JA refusing an application on the basis of a commerciality test, although some applications were withdrawn and replaced with a production licence application when refusal appeared imminent. In many of the examples of actual refusal, the commerciality had already been drawn into question by other circumstances, so it is arguable that the decision to reject the claims on commerciality were not solely based on an independent analysis of the financial data provided.

Some submissions to the JWG argued that regulators should consider strategic arguments in assessing commerciality¹³, make a distinction between the commerciality for domestic

¹³ Should a commerciality test include a strategic test, this would no longer be a commerciality test, but would include valuation of strategic domestic benefits to gas supply (a form of override of commerciality). Non-market solutions may be justified in situations where the market has failed or in cases of overriding public policy interest.

and international markets, or otherwise start with the assumption that all major LNG projects have the capability to supply domestic gas.¹⁴

As has been noted in this paper, the development of large oil or gas projects, and in particular LNG projects, are highly capital intensive and encompass a range of technical and financial risks that necessitate risk sharing between a number of companies who come together as venture partners for a particular development. It is acknowledged that in these joint ventures there may be a range of views and interests at play which will influence views about the commerciality of that development. These views will be shaped by the strategic interests of the individual venture partners and may not necessarily coincide with the timely and efficient development of Australian petroleum resources. To safeguard the interests of the Australian Government as the steward of these resources with a legitimate concern in ensuring their timely development, it is worth exploring mechanisms whereby the objective assessment of commerciality could take into account the differing views on barriers and options which venture partners may hold for a particular development.

Issues

Assessment of the commerciality of an application is inherently difficult, but it is particularly challenging to differentiate between the situation where no gas contracts are made due to lack of effort, and the case where parties are legitimately unable to bridge their differences on terms and conditions. This concern has particularly been raised in the JWG report in relation to the forming of domestic gas supply commitments.

In undertaking the detailed assessment of the proposals by the applicant, the JA relies heavily on information provided by the applicant, plus the JA's in-house technical expertise in State/Territory and Commonwealth departments.

Introduction of a strategic element to a commerciality test would fundamentally change the purpose of this test. While the current test requires the assessment of all reasonable options for development, the result does not take away the right of the lessee to select the best development option. For example, the JA may consider domestic gas supply or third party LNG options are commercial and force a move to a production licence, but the applicant is able to commercialise exclusively for a different option, such as an owned and operated LNG project.

Options

- Status quo;
- Less sympathetic treatment of gas marketing difficulties in guidelines;
- Presumption that domestic gas markets exist until proven otherwise;
- Requirement of more detail on alternative commercialisation options;
- Requirement of high quality independent financial analysis or verification;
- Introduction of a strategic importance aspect of the commerciality test;

¹⁴ One submission proposed that the test be redefined to consider "if a field is believed to be capable of supplying the domestic market on a commercial basis then this should be the test". This would mean that domestic gas supply would be the basis of any test of commerciality

- Include provision for the JA to verify commercial negotiations with third parties; and
- Include provision for the JA to seek the views on commerciality of individual joint venture participants.

Discussion

It remains a fact that commercialisation of gas is usually more difficult than for oil, so reflecting that reality in the guidelines is appropriate as long as recognition is given to the fact that domestic and international opportunities are now much greater than when the guidelines were developed.

Requiring a detailed assessment of a broad range of options may be counterproductive if those options are inherently unrealistic. On the other hand, it is reasonable to expect that if an applicant argues a superficially attractive option is not commercial, that supporting arguments be provided. Such options may arise in the case of gas fields close to domestic markets or infrastructure. There are some models of how this evidence might be supplied, including documentation required to support applications for variations to exploration title conditions.

It is also important that the industry understands any new standard, and that realistic expectations are communicated in the guidelines.

Robust assessment of commerciality requires effective financial analysis. This could be undertaken either within the JAs or independently. Independent analysis of the applicant's data may be extremely expensive, and may not necessarily lead to outcomes materially different from competent in-house engineering analysis. The methodologies used must be consistent and defensible across jurisdictions, and the weaknesses and sensitivities of various modelling approaches must be well understood.

In seeking the views of individual joint venture participants, it is acknowledged that venture agreements may restrict the ability of venture parties to make individual submissions to the JA. However, there may be merit in exploring mechanisms to ascertain how this may be achieved without unduly affecting the ability of the joint ventures to be formed and to operate in a manner which facilitates the development of petroleum projects.

Draft conclusions

- 5.1 Recognise that, despite the tightening in international and domestic gas markets, there are many aspects of gas projects which make them more difficult to commercialise than liquids projects.
- 5.2 It is essential that all reasonable development options be progressed and, given the strategic importance of domestic gas to Australia, this should include an explicit treatment of the potential of the project to supply to the domestic gas market.
- 5.3 Recognise that the market will determine where gas will ultimately be sold. It does not see any strong evidence of market failure in this regard.
- 5.4 Consider negotiations with potential customers must be conducted in a timely manner and in good faith. The JA may request evidence in writing of meetings,

- correspondence and discussions to support any claim that it would be impossible to develop a sale agreement.
- 5.5 Give guidance on the commerciality test to minimise investor uncertainty and clearly articulate the Australian Government's objectives with respect to development outcomes.
 - 5.6 Will facilitate the development of consistent and rigorous modes of assessment between jurisdictions.
 - 5.7 Explore mechanisms to allow the submission of information on commerciality by individual joint venture participants (or leaseholders).

5.2 Title vs. Project Assessment

Background

The provisions of the legislation and guidelines with respect to retention leases are based on an assessment of a title – that is, the test of the commerciality and technical viability of the reserve is on a title basis, rather than a project or field basis. There is no capacity in the Act to amalgamate titles in cases where adjacent titles are under common ownership, or where amalgamation will maximise resource development or underpin a major project.

Some major projects, particularly LNG projects, may be made up of a large number of retention leases, and a phased development of these titles may be necessary if there is a need to bring resources on stream in stages to support a major project. Given there is experience of LNG contracts running for 20 years in Australia, and that the projects have a life much greater than this, it seems that a test requiring a field to be commercialised in 15 years may not always be appropriate. That being said, while there are benefits to providing certainty to such large scale investments, offshore petroleum legislation arguably never gave the right to "warehouse" gas over such a long period.

Similarly, given the size of the domestic market, it may be inappropriate to judge a number of titles as potentially commercial, if developing only one of them could satiate available market demand.

It is also recognised that a staged development of a number of reservoirs may in some cases support optimum rates of recovery in good oilfield practice. In these instances, it would be unwise to insist upon the development of reservoirs without consideration of their interaction with other titles.

Issues

The JA is required to assess each application on a title by title basis, but in doing so may not be able to make judgements which balance the needs of investors in major projects with the expectations of the community. It may also not be able to reasonably assess the impact of commerciality of a number of competing or complementary projects.

In cases where petroleum pools related to major projects extend across titles and blocks, and common ownership exists between these areas, it may be advantageous to amalgamate these titles into one. While this would streamline applications and provide

greater incentive for major project investments, care would need to be taken that satellite fields are not stranded inside a larger title or major project strategy.

Options

- Continue to assess on title by title basis;
- Apply the commerciality test on "whole of project" basis;
- Amalgamate titles related to a joint reservoir or major project where common ownership exists; and
- Some combination of the above.

Discussion

There is no single answer to this dilemma, so it is likely that any approach by the JA will need to maintain sufficient flexibility to take into account specific circumstances. Major projects like LNG developments require huge investments of capital and run over very long terms, and it is important that such investments not be made any harder by introducing risk associated with title to resources. There may be elements of reserves in such large projects which are not relevant to its overall viability, and which could be commercialised in advance of the titleholder's preferred schedule. While the industry should be given clear surety in the first case, it is reasonable to assume there may be a public benefit in seeing pressure applied to commercialise reserves as soon as possible in the second case. A difficulty will be in making this judgement about what is material to the project's viability, particularly as many of these projects are designed with the concept of expansion in mind.

A distinction needs to be made between projects and reservoirs. With regard to reservoirs that cross title boundaries and are subject to common ownership, there is a *prima facie* case for merging the two titles into one, for administrative and planning simplicity. A similar claim to efficiency could be made in the case of major projects, where a number of reservoirs across multiple titles form the basis of a major development. A key difference is that such reservoirs may not necessarily be straddling title boundaries, but are seen by the applicant as part of an extended development strategy.

Titles are subject to a complex range of ownership and joint venture structures, which may apply to a single field across multiple titles, therefore defining 'common ownership' can be difficult. In cases where joint venture partners are aligned or the titles are under a 100% ownership structure, the flexibility provided by case-by-case assessment of title amalgamation could deliver real benefits.

While amalgamation of titles underpinning a major project would significantly simplify commerciality tests, administration, and determination of conditions such as work programs, it may also present difficulties in terms of resource development. In cases where a number of distinct petroleum pools exist within multiple titles, the larger or more strategic pools may strand satellite fields that are marginal to the major project, but are not suitable for a small, stand alone development. This may be a particular concern if the commerciality of these satellite fields were to change in the future, independently of the larger project. For example, if infrastructure was developed in close proximity to a small

field under a larger title, there would be no avenue for the JA to encourage development of this small field.

The JA also needs to consider that, in assessing the market impacts, not all retention leases in a major LNG project will be suitable for supplying the domestic market. In maintaining title-by-title administration, it may be possible to strike a balance in such cases by examining those titles in a project with potential to supply the domestic market first, on the basis that if they are deemed commercial and would satiate demand, the test for subsequent leases would be against an LNG export option only. Care would need to be taken with such an approach because projects such as gas-to-liquids fuels could offer domestic gas opportunities on the same very large scale as LNG opportunities. If these reservoirs were within a single title, no leverage would exist to promote development of a domestic supply outside of the major LNG project.

Draft conclusions

- 5.8 Recognise that long term certainty of title is essential to major investment like LNG projects, and will not act to compromise this title where reserves are essential to meeting contractual commitments and the overall viability of the greater project. In making a decision on commerciality, the JA should attempt to provide certainty to investors in major projects that they have adequate reserves available to meet contractual commitments, without granting an extended right to hold reserves for all potential expansions.
- 5.9 Consider that the community has a reasonable expectation that reserves will not be indefinitely warehoused on the basis of potential future expansions, and will subject such claims to close scrutiny. Should a lease have a viable development path already, and not be essential to a major project, there is a strong expectation that it should be developed.
- 5.10 Consider that where a retention lease application might be rejected on the basis of commerciality, it takes regard of how competing projects might affect the market outlook.
- 5.11 Consider the Act should be amended to provide the JA the ability to amalgamate retention leases under common ownership where this has clear benefits for administration and planning, and will develop criteria for the JA to determine where amalgamation would be appropriate, with particular focus on the implications for timely resource development.

5.3 Mid-Lease Commerciality Reviews

Background

The DA may request a re-evaluation of the commerciality of the retention lease once during the term of the title (s136(5)). If the JA is satisfied as a result of this review that the lease is now commercially viable, it may revoke the retention lease. These "mid-lease" reviews do not appear to include a re-assessment of whether the lease will ever be viable.

The guidelines note that a re-evaluation may occur where the JA has reason to believe the conditions applying at the time of the grant of a lease have changed and that the

development of the petroleum resources in the lease area may have become commercially viable or unlikely to become commercially viable in 15 years.¹⁵

The re-evaluation is conducted by the lessee at the JA's request, and may result in the requirement for additional work to be carried out. This additional work could involve work "to be carried out additional to that required by the lease conditions. This additional work could involve work in, as well as outside the lease area, including seismic surveying, reinterpretation of existing data, simulations, cost or marketing analyses but cannot involve the drilling of a well."¹⁶

An amendment was made to the PSLA in 2002 to restrict this number of reviews to one. Additional reviews were seen as unnecessary compliance costs on industry.

The review provisions have been rarely used, but may be relevant given the current rate of change in the commercial environment.

Issues

The need to confirm the assumptions behind the original assessment of commerciality remains valid but should be balanced with the need to provide security for investors. The possibility of a review also brings with it the risk of cancellation or new work requirements.

The McLennan Magasanik Associates (MMA) report for the JWG study also noted what it termed to be a "loophole" in the PSLA, in that the mid-lease review does not appear to revisit the question of whether a lease will be commercial in 15 years. It suggested amending the terms of the mid-lease commerciality review to allow the question of whether the discovery will be commercial within 15 years to be considered – i.e. if it looks unlikely to be commercial in 15 years this Retention Lease should be cancelled. While this loophole should be closed for the sake of consistency, it is recognised that it may have little significance on the rate of release of areas as the second test is inherently subjective and is regardless reviewed every five years.

Options

- Status quo;
- Change the frequency of commerciality reviews;
- Clarify the conditions which might trigger reviews;
- Clarify the types of work which might be required in response to a review;
- Change the OPGGSA to allow the review to consider the issue of whether the lease will be commercial in 15 years (i.e. "loophole" closed); and,
- Annual reporting of progress towards addressing barriers to commercial viability to assist identification and targeting of commercial reviews where leaseholders have not made application for a production licence.

¹⁵ Guidelines, p12

¹⁶ Guidelines, p12. The PSLA is less expansive "[the lessee should]...re-evaluate the commercial viability of production in the lease area (otherwise than by the drilling of wells) and inform the Designated Authority in writing of the results of the re-evaluation." PSLA S38H(3).

Discussion

The JA's position on mid-lease reviews should be related to its view on whether work programs are necessary, and its position on monitoring conditions and ensuring compliance. Commerciality reviews are another mechanism of ensuring that the title continues actively towards development, although it is recognised that there are many influences on commerciality which are outside the direct control of the titleholder (e.g. movements in prices). The review process therefore introduces a risk to title which is outside the lessees' control, and therefore should only be used with restraint.

The potential risk of a review may be offset by ensuring that conditions for reviews are clearly specified and agreed prior to offering the lease. Additionally, the scope for renegotiating the work program could also be limited to minimise the potential uncertainty of a review. If it is worth setting a trigger for a review, thought will also need to be given to how it will be monitored.

The above discussion relates to a review at the JA's request. There is some uncertainty as to the obligations of lessees to volunteer a reassessment of commerciality, or whether this obligation could reasonably be added as an enforceable title condition. The enforceability is probably not of major concern given the JA has at least one opportunity to formally request a review, but it may be the need to volunteer reassessment is a useful principle to communicate to lessees. It should be noted that the existence of a retention lease does not preclude a titleholder from applying for a production licence at any time, which reduces the need for the lessee to volunteer a review.

The issue of the inconsistency in the Act with regard to the commerciality test seems minor. The determination of whether a lease has potential to be commercial in 15 years is inherently subjective, so revisiting this mid-lease is unlikely to change the analysis. There seems little to be gained from this modification.

Draft conclusions

- 5.12 Recognise that the use of mid-lease reviews should be minimised to avoid uncertainty to investors where legitimate efforts are being made to work towards commercialisation.
- 5.13 Consider that triggers for mid-lease reviews should be specified at the time of assessment of the retention lease application, and agreed with applicants;
- 5.14 Consider leaseholders should be required to volunteer a revised assessment of commerciality should the circumstances surrounding the original application materially change;
- 5.15 Recommend circumstances for mid-lease commerciality reviews should be clarified to give certainty for investors;
- 5.16 Recommend reviews should revisit the appropriateness of the work program conditions for the remainder of the term, within the constraints of the Act noted above, but considers major changes would not be expected unless there were threshold changes in development options; and,
- 5.17 Consider the so-called "loophole" referred to in the MMA report is not significant and requires no immediate action.

5.4 Third Party Claims

Background

Linked to the previous comments on transparency is a theme in the JWG report that third parties may claim a reserve covered by a retention lease is commercial, and therefore the lease should be cancelled or an application refused. There are few examples of specific third party claims to date, which may or may not be related to a lack of transparency. If transparency is improved, it can be expected that the incidence of third party claims would rise.

The October 2007 Guidance Note says that the "JA will take note of third party claims that particular fields are commercially viable but the assumptions used by the third party will be tested in the same way that an applicant's claim is tested. Claims and assumptions used by applicants or third parties will not be accepted if found to be unreasonable".

There is only one example to date of such a claim, whereby a third party challenged the JA's decision on the commerciality of a gas field. Both jurisdictions in the JA requested further information from the third party in support of its claims. This information was analysed by both jurisdictions, who individually concluded that the information provided did not substantiate the claim.

In that instance, the JA encouraged the third party to provide additional information substantiating the claim, and said this would be reviewed with interest. Internal briefing to the JA stressed it was important to check these claims, but noted it was also dangerous for the investment environment to challenge retention lease applications on this basis without substantial evidence. The JA ultimately met with the third party and tested its claims with the leaseholder. The decision was also identified as contentious and elevated for ministerial consideration.

Issues

Third party claims are inherently difficult to substantiate, and may lack detail due to inability of the claimant to access commercially sensitive data held by the lessee. That being said, they may bring forward information that is relevant to the JA's consideration of commerciality.

If transparency is improved along the lines recommended in section 4, it can be expected that the JA will have a greater volume of third party claims to consider, and it will be important for both the claimants and the applicants to provide clarity regarding how this information is treated. Assessment of such claims may also extend the time period of the retention lease application, and this should be made clear in the guidelines.

Options

- Ignore third party claims;
- Status-quo, treat third party claims as described in the Guidance note;
- Give third party claims greater status in the assessment process; and,
- Give increased opportunity for third party comments through greater transparency.

Discussion

Third party submissions may potentially provide useful information to the JA in assessing commerciality, but will not *necessarily* do so. It is therefore important to access useful information without unnecessarily delaying the assessment with spurious claims. Claimants should be given realistic expectations as to how their information will be treated to avoid them going to unnecessary expense in preparing submissions.

As discussed under Section 4, it is intended that additional information will be made publicly available for third parties, so that considered comments can be made. These claims should be reviewed carefully but should be substantiated before affecting the assessment outcome. The consideration of this information should not be seen to give third parties any particular standing in the assessment process, nor any right to the area should the title lapse. It would also be reasonable to allow applicants to respond to specific claims by third parties if the claims appear relevant to the JA's consideration. Guidelines should be clarified on the treatment of third party claims to provide certainty to investors.

Draft conclusions

- 5.18 Facilitate third party comments on retention lease applications by increasing transparency (see recommendation 4.2), in that such comments may provide additional information to assist the JA in assessing commerciality. Third parties would be given a fixed period in which to provide comment (for example, 2 weeks).
- 5.19 Consider relevant claims may be tested by the JA, but this does not give the claimant any official standing in the assessment process, nor any rights to an area or petroleum products.
- 5.20 Consider third party claimants to not have the right to access confidential data related to the application. Information such as that outlined in recommendation 4.2 will be made available to enable third parties to make relevant claims.
- 5.21 Recognise that while a claim may influence the JA's assessment of commerciality, it does not take away the titleholder's right to develop a resource as it sees fit, regardless of which development option the JA considered was commercial as long as the alternative option delivers the same or an earlier start-up date.
- 5.22 Recommend the guidelines be revised to include a clearly defined process for third party submissions and claims.

6. Lease Application Refused - Treatment of Vacated Acreage

Background

If a retention lease application is refused the applicant has 12 months to apply for a production licence (if deemed commercial) or the location lapses and the area returns to an exploration permit (if deemed not to be commercial in 15 years). In the case of the former, if the application for a production license is not made the blocks are revoked under s188 and revert to the Commonwealth as vacant acreage.¹⁷

¹⁷ Guidelines, p12

In the case where this area contains a confirmed discovery of hydrocarbons which the JA has determined as commercial, there may be a heightened interest from third parties in accessing this acreage and progressing it to commercialisation.

Issues

Currently the only mechanism for re-allocating this acreage under the OPGGSA is to include this in the regular acreage release for bidding as an exploration permit, but this may further delay possible development. It may also be problematic in that where a known petroleum resource exists, further appraisal is not considered part of the work program and the drilling of exploration wells in the area may not be desirable or efficient.

Options

- Status quo – include in the regular acreage release under the work program bidding system;
- Direct reallocation of the title by the JA to parties interested in development; and,
- Auction of the area.

Discussion

It is difficult to envisage a non-competitive allocation system that would consistently lead to efficient outcomes. Under the OPGGSA exploration titles can be allocated by work program bidding, cash bidding, or a hybrid work/cash system under s115¹⁸. Current practice would be to include vacated areas in the annual acreage release and allocate under the work program bidding scheme. This may not be an effective way of allocating areas where there is already good knowledge about the geology and there are potentially strong competing interests, as there is a potential for bidding fieldwork in excess of that which is efficient or could reasonably be carried out. The current selection criteria also do not count appraisal activities as part of the bid, which may similarly be a problem in relinquished areas. As a matter of policy the JA does not use straight cash bidding as it is believed to divert limited funds away from exploration.

Draft conclusions

- 6.1 Reallocation of "vacated" retention leases should be on a competitive basis, without the government directing allocation or giving the area to a particular party; and,
- 6.2 Consider that in the case where the JA views that the geology is well understood and it considers the area contains a potentially commercial discovery, the area should be allocated by cash or s115 bidding, rather than through the acreage release system.

¹⁸ Section 115 is an allocation method for areas which were previously under lease, licence or where a location was surrendered or cancelled. It pre-dates other cash bidding in the Act and is essentially a cash/work bid hybrid. It appears to be in the Act to deal with the situation where acreage contains known discoveries. Under s115, the JA decides which bids have acceptable work, then decides between these on the basis of cash. It was used in Release 1 of 1986, where area 86-G1 was offered under s23 of the PSLA as it was previously under a location – the final bid was \$1.2m plus 4 wells and some seismic surveys.

7. Lease Application Refused – Production Licence Granted

Background

If a lease is declined because the development is considered commercial, the applicant has the option to apply for a production licence. Once a production licence is granted, the licensee has five years to move to production stage. Under s166, production licences *may* be terminated if operations do not commence in five years:

166 Termination of life-of-field production licence if no recovery operations for 5 years

(1) *If:*

- a. *If a production licence is a life-of-field production licence; and*
- b. *No petroleum recovery operations under the licence have been carried on at any time during a continuous period of at least 5 years;*

the Joint Authority may, by written notice given to the licensee, tell the licensee that the Joint Authority proposes to terminate the licence after the end of 30 days after the notice is given.

(2) *At any time after the end of 30 days after the notice is given to the licensee, the Joint Authority may, by written notice given to the licensee, terminate the licence.*

(3) *In working out, for the purposes of subsection (1), the period in which no petroleum recovery operations for the recovery of petroleum were carried on under a licence, disregard any period in which no such operations were carried on because of circumstances beyond the licensee's control.*

Issues

The five year "limit" allows both for the development of a production facility when a new lease is granted, and also a reasonable time before termination at the end of the life of the facility. In the case of the former, the five year time limit is part of the reason that companies will apply for a retention lease, regardless of the fact that the resource may currently be commercial. Titleholders may fear that even minor delays to the schedule of a large scale LNG development may breach the time limit and result in a risk to title.

LNG developments are being undertaken on an increasingly large scale. The size of the development and competition for resources is a critical factor in the time needed to bring a project to production. A five year limit on the commencement of production may no longer be appropriate given these constraints. Dynamic market conditions can change these constraints, which would affect development timeframes. Any time limit imposed needs to be appropriate in a range of future circumstances.

Options

- Status quo – leave the current five year limit;
- Change the time limit; and,
- Clarify the circumstances where this limit will be extended.

Discussion

The five year timeframe is essentially arbitrary, but may have been set to balance both start-up and end-of-licence timeframes. It is arguable that these periods should be different, especially in the case of large scale LNG projects which require considerable efforts to develop. On the other hand, it would be difficult to argue that the five year time limit at the end of field life should be extended. Through discussions between the applicant and the JA, a reasonable time frame for development to production could be determined, and included in title conditions. Some parameters for this broad discretion are needed, such as a minimum of four years and a maximum of seven years, to give some initial certainty to industry and government.

While it is true that there is a possibility that the licence may be cancelled, s166 clearly gives the JA the option *not* to terminate the licence (i.e. "may"), and further limits the circumstances under which the JA can actually exercise this power. It is possible to imagine many ways in which an applicant might counter a move to termination if it had been moving with best endeavours to develop a project. There is also the constraint that moving to terminate without a strong justification would affect Australia's investment risk profile.

If an applicant for a retention leases had sufficient confidence that the JA's use of this power would be very limited, it may be more willing to accept refusal of the retention lease application and a move to a production licence. In this sense, further guidance on how the JA sees the use of these powers may be warranted. Care would have to be taken to ensure that the provisions were not so flexible as to make a production licence a retention lease under another name.

It must also be taken into account that not all petroleum projects require lead times in excess of five years, and consideration should be given to how this may be accommodated to ensure timely development of non-LNG and oil projects.

Draft conclusions

- 7.1 Consider production licences should not become *de facto* retention leases and should continue to require production within a limited time frame, usually five years.
- 7.2 Consider that the Act should be amended to allow the JA to decide on appropriate time frames (between 4 and 7 years) before production in the case of major projects with long lead times. At the end of field life, it would remain that licences are terminated 5 years after production ceases.

8. Further Issues

This paper broadly covers a range of issues related to the structure and policy of retention leases. A number of positions are proposed in the recommendations on these issues, and discussion is welcomed on these recommendations and other alternatives.

An important caveat on the above is that the scope of the review is not to directly address the issue of domestic gas supply concerns, but to ensure that these leases operate in a manner appropriate to the current operational environment. There are a number of synergies which are explored which should further encourage commercialisation, and therefore indirectly benefit domestic gas supply. While beyond the scope of this review, further consideration might usefully be given to how governments might use information from the assessment process in developing broader facilitation policies to further the development of domestic gas markets and infrastructure.

Comments and submissions should be provided **by Friday 14 August 2009** and be addressed to:

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