

July 2008

National growth engine sputters: out of gas

While the state of Western Australia mops up the short-term damage caused by the Varanus Island gas explosion on June 3, the medium and long-term fall-out of this disaster is just starting to be calculated.

The explosion cut 30 per cent of WA's domestic gas supply, forcing businesses across all industries to operate on a limited gas allocation. West Australian households have been urged to reduce their gas consumption in order to increase the supply available for industry.

Gas is WA's principal source of energy, accounting for 60 per cent of the state's energy supply (coal accounts for 35 per cent). Apache Energy, the owner of the Varanus Island plant, estimates it will take until the middle of August to restore just 57 per cent of lost supplies. The plant is not likely to be returned to full operating capacity until December.



WA's peak industry body, the Chamber of Commerce and Industry, estimates the crisis has so far cost Western Australia \$2.4 billion in lost turnover and continues to cost the state hundreds of millions of dollars per week.

The WA Government claims the crisis cost the state about \$900 million in the first month and is likely to cost \$1.8 billion by 2011-12. However according to CCI estimates, if the gas supply remains restricted until December the overall cost of the crisis could reach \$6.7 billion, or around three per cent of business turnover. A CCI survey of its members suggested that up to one per cent of its workforce is at risk of being stood down or made redundant. If extrapolated across the entire WA workforce that could translate into 11,350 lost jobs.

While this is clearly a disaster for Western Australia – crippling business, costing jobs and inconveniencing millions of people – the effects

will not stop at the border; what it means for the rest of the country is yet to become clear.

National crisis?

Australian Prime Minister Kevin Rudd described the WA gas crisis as “a serious matter for all Australians.” “If there is a significant impact on WA economic activity, on growth and on exports from that state, given WA's crucial significance to the overall performance of the Australian economy, there will be wash-through for us all on this over time,” Mr Rudd said.

Over the past year, the WA economy has contributed about 20% of the nation's growth. At a time when a chill wind is blowing through global markets and WA's resources boom is keeping the



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heat in the Australian economy, the only question is: will the gas crisis choke the national economy? The Reserve Bank of Australia estimates it will shave one quarter of a percentage point from GDP growth. What that means in terms of businesses closed and jobs lost, only time will tell.

Businesses across WA are being forced to come up with creative responses to deal with the impact of the crisis on their specific market. The most common strategy has been to reduce employees' working hours or keep them active through redeployment. Some businesses are relying on staff using up accrued leave entitlements – mostly voluntarily, but in some cases, compulsorily. Others are being forced to make staff redundant.

In an effort to quantify the financial impact of the gas crisis, the WA Chamber of Commerce and Industry undertook a survey of 300 enterprises of all sizes in a variety of industries. The survey found that almost half of all respondents had been affected in some way by the reduction in supply.

Businesses operating in the manufacturing industry reported being hit the hardest, with nearly 62 per cent affected in some way and production down an average of 45 per cent. Most disturbing was the prediction that if the gas crisis continues for three months, 15% of respondents expect to close their doors for good. If the crisis lasts six months, almost 19% expect their businesses to fail. If it lasts 12 months, more than 20% may fail.

Primary impact

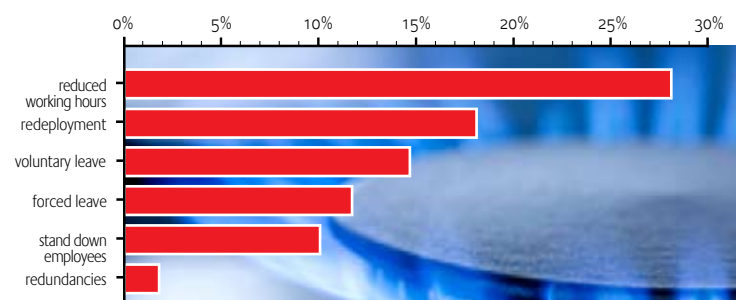
In the mining sector, at least 12 mines producing nickel, gold and copper declared that the gas outage has had an impact on their production targets. Minara Resources, Australia's second-largest producer of nickel, has cut its production target by 23 per cent. Newcrest Mining – whose Telfer gold mine generates 30% of the company's earnings and was almost entirely dependent on

Apache for power – expects its gold and copper production to be significantly impacted.

Iluka Resources Limited, a major participant in the global mineral sands sector, was forced to shut down its mineral sands extraction operations and limit its mineral-processing activities. It announced it would be forced to consider laying off workers if the power crisis continues longer term.

Santos, Tap Oil, Babcock, Brown Paper and Alcoa have all indicated they expect the gas crisis to impact on their bottom line. Alumina Limited predicts its earnings for June to be down \$13m-17m while Wesfarmers says it is losing \$20m a month.

HR policies used to cope with gas crisis
% of CCI survey respondents affected



Source: CCI

Aftershocks: the second-tier impact

While the direct impact of the gas shortage has been felt by many businesses, the more far-reaching impact is likely to be to the second and third-tier victims. This is not restricted to those businesses directly affected by the reduction in energy supply – these are businesses whose customers or suppliers have been impacted: construction; hospitality; health and community services; the retail trade.

These indirect and flow-on effects are already starting to make themselves apparent in unexpected industries. A hotel laundry service supplying around 85 per cent of the state's

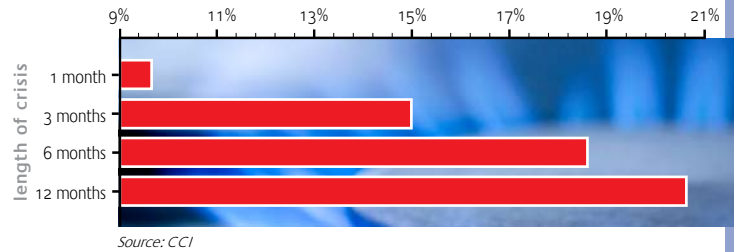
hospitality industry was forced to temporarily shut down following disruptions to its gas supply. This left many accommodation providers including the major hotels being forced to turn away customers or able to provide only a reduced service. Some hotels have responded by sourcing additional supplies from the eastern states, trucking dirty linen and towels across the Nullarbor and bringing them back clean and pressed – at substantial additional cost.

The Food Industry Association of WA says major industry players are growing increasingly fearful the gas crisis may cripple operations permanently. Harvey Beef, one of WA's biggest beef suppliers, is operating at just two thirds of production capacity, whilst milk processor Fonterra was forced to stop production at its Balcatta plant as it transferred power from LPG to diesel. It fears the crisis could result in one million litres of milk a day being poured down the drain.

Australian Hoteliers Association members were fortunate to secure an alternative supply of CO₂, allowing them to continue pouring draught beer. The CO₂ shortage forced Coca-Cola Amatil to temporarily scale down operations at its Kewdale factory.

The building industry is also in strife: the manufacturers of many key construction materials – cement, asphalt, timber – have been severely affected by the gas crisis. Midland Brick, a supplier of clay and masonry bricks and pavers, was forced to close for a week, placing at risk tens of thousands of jobs in the construction industry. After buying alternative power at two to four times the usual cost, the company has restarted its brick kilns but remains unable to guarantee long-term production because its future power requirements will have to be sourced daily on the spot market.

Possible business closures from gas crisis
% of CCI survey respondents likely to close



Long-term impact?

Higher energy costs associated with the gas shortage will also add significantly to the cost of doing business. Gas spot prices have doubled since the explosion, while many businesses have been forced to shift from gas to more expensive liquid fuels, such as diesel. Demand for diesel has jumped 40 per cent since the explosion.

Now in its sixth week, and expected to continue for many more months, the situation may turn out to be as serious as the 1998 Longford gas explosion in Victoria, which virtually shut down many smaller businesses and left consumers enduring cold showers for weeks. Industry estimates are that Victorian businesses lost \$4.3b in revenues, export earnings fell by \$200m, and of those businesses directly affected, around 50% of staff were laid off.

At this stage, WA's gas crisis looks likely to last longer and have a deeper long-term impact on the state than Longford did for Victoria.

As the secondary and longer-term impacts of the gas crisis start to make themselves apparent, businesses, financiers and their advisors need to be alert to signs their clients or clients' markets have been significantly damaged by the incident.

Conclusion

The impact of the gas explosion will not be restricted to companies within Western Australia, although at this stage it is difficult to predict which businesses will be affected and how. Certainly lenders should be reviewing their portfolios for exposure to western assets, to mining businesses or, say, manufacturing businesses reliant on WA-sourced energy. Companies directly affected should review their insurance cover to see if they have any recourse under cover for losses caused by interruptions to business.

At Ferrier Hodgson we believe that for companies in the first to third tiers of impact, it is critical to identify problems caused by the gas crisis and respond to them before the damage they have caused becomes fatal for the business. We recommend businesses undertake an urgent review of operations, including the following key elements:

- 1 Sensitivity analysis of cash flow modelling to determine the effect on operations of rising fuel costs or a fuel shortfall
- 2 Consideration of the downstream and upstream implications for suppliers and customers, including whether the additional cost of fuel can be passed on
- 3 Review security of energy inputs
- 4 Develop contingency plans with the workforce, covering voluntary leave, potential redeployment to other projects and more flexible working hours

If you would like assistance in conducting such a business review, or advice on how to go about it, please do not hesitate to contact your local Ferrier Hodgson office.



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