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SUBMISSION ON THE EXPOSURE DRAFT OF THE AUSTRALIAN DOMESTIC GAS SECURITY MECHANISM (ADGSM)

The Australian Industry Group welcomes the opportunity to make a short submission on the exposure draft of the proposed Regulations and Guidelines to underpin the ADGSM. The current situation in the Eastern Australian domestic gas market is economically ruinous. Gas prices are soaring far above even the most pessimistic expectations. They have been driven well above export parity by a mismatch between supply and demand, in turn largely caused by the growing pains of the Liquefied Natural Gas (LNG) industry in Eastern Australia.

With new supply options and efforts to shift demand taking years to deliver substantial change, even if excessive restrictions on gas production in some regions are relaxed, the market is likely to rebalance through the closure of a significant fraction of Australia's gas-using industries. Those industries include the chemicals sector, where methane and ethane are essential feedstocks for many high-value-added products; and a wide range of other metals manufacturers, food processors, machinery and equipment producers and more, for whom gas is a clean and efficient fuel for heat and power. The rise in gas prices is also heavily influencing the rising price of electricity, with severe impacts on an even wider range of businesses.

The extraordinary risks of this situation and the lack of viable immediate alternatives has led Ai Group and the Government to the same reluctant conclusions: that gas must be diverted from exports to domestic use, and that while commercial arrangements like gas swaps can achieve this, credible export controls are needed as a backstop. This is a significant intervention and Ai Group has not called for it lightly. It is regrettable that public and commercial errors over the past decade have led Australia to this predicament, and export diversion should only last until other measures to balance the market and improve transparency and competition can deliver.

In the brief time available to consider the exposure draft of the ADGSM, we and our member businesses have only been able to make a limited assessment. While we more than understand the urgency of reform, this is a complex intervention to design in such a short period. We draw some comfort from the fact that the enabling regulation and, even more so, the guidelines, can be amended with reasonable ease if problems emerge.

With that said, our best judgment is that if the Government has the necessary will, the proposed system is capable of being used to temporarily rebalance the Eastern Australian gas market. While we suggest some improvements below, we are hopeful that if the Government puts the ADGSM into place and leaves no doubt about its willingness to act, the gas industry will respond constructively and obviate the need to fully invoke this system.



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Comments on the Customs (Prohibited Exports) Amendment (Liquefied Natural Gas) Regulations 2017

The draft Regulations provide a broad power for the Resources Minister to prohibit exports of LNG when a domestic shortage is anticipated, and to make appropriate exceptions to this prohibition. The main limitations on this power are the need to consult with several other Ministers and the Prime Minister, and the sunseting of the Regulations on 1 January 2023. In addition the Minister must make the determination that a year is a shortfall year by no later than 1 November in the previous year, following at least 30 days' notice that a determination is being considered. Decisions are subject to judicial review, but not merits review. The bulk of the design of the ADGSM is contained in the Guidelines which explain how the Minister intends to make decisions, rather than in the regulations.

Our best judgment is that the broad power granted is sufficient and appropriate for the purposes of ensuring adequate gas supply during the present crisis. While legal challenges to the system and decisions under it are possible, the terms of the legislation do not seem to add to the likelihood of challenges beyond whether the notice and consultation requirements have been met. The sunseting date appears adequate given the likely time frame for other supply- and demand-side options to deliver and the need, for reasons of international trade law, to demonstrate the temporary nature of this intervention.

The Regulations and Guidelines together appear to neatly solve an important constitutional and economic challenge: the appropriate treatment of gas exports from Western Australia and the Northern Territory. The proposed system allows the Minister to make a shortfall determination based on conditions in one part of the Australian gas market and issue full export permissions to exporters in other parts of the market. We are confident that this should allow the effective use of the ADGSM with respect to Eastern problems without adverse impacts on Western Australian gas exporters or gas users.

Comments on the Customs (Prohibited Exports) (Operation of the Australian Domestic Gas Security Mechanism) Guidelines 2017

There are three critical questions that must be answered in order to invoke effective export controls under the proposed guidelines:

- is there a gas shortfall in a given year?
- what proportion of any shortfall should be met by net deficit exporters? and
- which (if any) exporters are in net deficit?

The question of whether a gas shortfall is expected is vital but projections are always complex and necessarily involve judgment calls. The Government appears to contemplate a process where forecast gas production is compared to consumption projections that are based on an assumption of export parity pricing. While there may be some argument about the precise value of export parity, this approach is appropriate; it is reasonable to expect that gas should be available to buy within Australia at prices comparable to the return from exports. Demand projections from the Australian Energy Market Operator and production forecasts from the Australian Competition and Consumer Commission's ongoing inquiry are likely to play key roles. We would also urge the Government to pay attention to any gap between export parity pricing and the prevailing prices being offered to gas users at the time of assessment. The large gap currently evident is *prima facie* evidence of a looming shortfall; we are not aware of any other factors that could plausibly explain the emergence and size of this gap.

The process for determining how much of any shortfall to assign to gas exporters – the Total Market Security Obligation (TMSO) – is not very clear from the Guidelines. The Minister appears to have scope to decide a TMSO equal to anything from 0% to 100% of the projected shortfall – and perhaps more. It is unclear what factors the Minister will take into account, other than advice from other Ministers and past performance by LNG Projects and LNG Exporters. From the point of view of gas users, this breadth of scope is not necessarily a problem as long as the Minister and the Government have the will to act. However, it may be better to establish clearer guidance – for instance, the presumption that the TMSO will be equal to the projected shortfall unless the Minister is satisfied that it needs to differ.

The calculation of whether an LNG exporter is in net-deficit – and thus subject to a share of the TMSO – appears to be the most complex and fraught element of the ADGSM. The calculation assesses whether the total amount of gas proposed to be exported is greater than the sum of an exporter's 'own gas' and contracted 'export compatible third party gas'. This raises the following issues:

- as drafted, the definition of 'own gas' includes any gas owned by the LNG Project as a whole; or gas owned by entities of the Project if that gas is both contracted to supply the project and was primarily developed for the purpose of the export. It does not appear that the latter qualifiers apply to gas owned by the Project itself. If this is correct, it is not clear what would prevent an LNG Project at risk of net-deficit from buying currently contracted gas outright and evading the ADGSM without improving supply. If this is not correct, the qualifiers should be applied to both forms of 'own gas'.
- Both 'own gas' and 'third party export compatible gas' refer to the question of whether gas was primarily developed for the purpose of supplying the export market. This is fine as long as the Government is satisfied that it can access sufficient evidence to make a reasonable judgment about the primary reason for development of a project. The lack of merits review of a decision is extremely important here.

Two other concerns relate to the impact the ADGSM may have on the availability of gas contracts to energy users.

- Firstly, it may be that contracting activity slows or stops until there is clarity on the Minister's decisions about calendar 2018 – which may take until 1 November 2017. Some gas users will have no choice but to sign new contracts in this period of uncertainty. This is probably an unavoidable consequence of a major intervention of this type, but it is important that the Government make timely decisions.
- Secondly, the year-by-year nature of the decision making could make it harder to obtain gas contracts that run more than one year out, which would have serious consequences for gas users' ability to manage their businesses. This risk can be reduced if the Government establishes a strong and clear approach to administering the ADGSM. We would also hope that the substantive steps which LNG exporters and others take to rebalance the gas market will have a predictable impact beyond a single year.

Our final substantive point on the Guidelines relates to consultation. Paragraph 8(8)(a) to (c) lists stakeholders with whom the Minister must consult, and (d) allows the Minister to consult others if they wish. The mandatory list does not include gas users in any form. The Minister should consult gas users in order to form a judgment about market conditions and the likelihood of a shortfall relative to demand, and it is appropriate that the Guidelines establish an expectation that they do so. There are many gas users and organisations representing gas users; to ensure a voice without establishing an unfeasibly broad obligation on the Minister, we suggest the following amended



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Paragraph 8(8):

- (8) Shortly after issuing the Minister's Declaration, the Minister will write to:
- (a) relevant market bodies and agencies; and
 - (b) all LNG Projects; and
 - (c) relevant Australian Government Ministers; and
 - (d) any significant gas users and organisations representing gas users that have notified the Minister of their desire to be consulted; and
 - (e) any other stakeholders with whom the Minister wishes to consult.

Again, the Regulations and Guidelines as proposed appear to give the Government scope to make the decisions necessary to alleviate the current crisis in the Eastern Australian domestic gas market, if the Government is willing. Both the rules and the market context have their complexities, and the time to devise a solution is short. We are keen to work with the Government and all stakeholders to get an effective solution in place as soon as possible, and to continue working as the ADGSM is applied – and refined, if necessary.

Should you wish to discuss the matters raised in this submission, please contact our adviser Tennant Reed on 03 9867 0145 or tennant.reed@aigroup.com.au.

Sincerely yours,

Innes Willox
Chief Executive