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AI GROUP SUBMISSION ON THE EASTERN AUSTRALIAN GAS MARKET STUDY

The Australian Industry Group (Ai Group) welcomes the opportunity to provide a submission to the Eastern Australian Domestic Gas Market Study. Maintaining a well-functioning gas market that reliably and efficiently delivers competitively priced gas is very important to Australian industry. We represent thousands of Australian businesses across a broad and diverse range of sectors. Many of our members use gas directly as a fuel or feedstock. Many provide equipment and services to gas producers or exporters, and every one of them relies on an electricity grid in which gas fired generation plays a vital role. Collectively our members employ more than one million people.

Concerning developments

Historically, reliable and competitively priced gas has been a source of competitive advantage in Australia. Many of our members have built their businesses around the expectation that Australian gas markets would continue to reliably and efficiently deliver competitively priced energy. It is important to them, and the broader Australian economy, that Australian domestic gas markets continue to function well. Recent developments in the Eastern Gas Market, including the forthcoming rapid market expansion in response to the advent of liquefied natural gas (LNG) exports from Queensland, uncertainty surrounding the outlook for supply and demand of natural gas and opposition from sections of the community to unconventional gas production, entail significant price rises and threaten reductions in the reliability of Australia's eastern gas markets. A doubling in wholesale gas prices now appears very likely under current policy settings and modest gas market scenarios, and prices could rise much higher, and much more suddenly, if policy and the market develop poorly. Either way there will be serious consequences for gas dependent industries in Eastern Australia, and more broadly via the role of gas in the National Electricity Market.

The Eastern Australian Domestic Gas Market Study (the Study) acknowledges that *“Australia’s gas markets will undergo major changes in the period to 2030 and that the scale and duration of this change is likely to have profound effects on other market participants. These effects will be exacerbated if impediments to supply or other constraints are imposed on the market’s ability to respond to the challenge of future market dynamics.”* The Study acknowledges that there is still considerable uncertainty in the Eastern Gas Market and that *“these uncertainties are manifesting as significant issues in the market.”*

The principal driver of change will be the transition of the eastern gas market from being solely domestic to one that is export linked. Consequently, *“the previously stable and long-term contract market for domestic gas supply on the east coast will be subject to market forces that are in part determined on the global stage.”* An Ai Group survey of Eastern gas users in mid-2013 found that many businesses were having difficulty securing gas supply on reasonable terms to replace contracts that will expire in the next few years. Furthermore, only one third of the surveyed businesses who were looking for a gas contract were able to secure multiple offers and the sort of competitive market for gas supply that we would expect. For those who had secured contracts, wholesale prices were substantially higher – particularly for those seeking contracts beyond two years ahead.

Our research, and our discussions with members and other market stakeholders, strongly suggests that some of the scenarios considered by the Gas Market Study are more plausible than others. In particular, it is the SKM modelling scenarios incorporating market power through a high level of ‘contract diversion’ that most closely match current industry experience. Our members confirm that LNG is impacting prices more quickly and in more locations than modelling that does not take account of market power would suggest. Victorian gas users seeking multi-year contracts are being offered high prices, if they are getting any serious offers at all, despite the physical impediments to sending Victorian gas to Gladstone for export. We would strongly suggest that market power scenarios be central to the development of the Gas Market 2020 Strategy.

Policy responses

The Study recognises significant imperfections in the current gas market, including the potential exercise of market power and a lack of transparency around many crucial matters, including pricing and the adequacy of CSG development to meet LNG demand. It is clear that there is considerable uncertainty in the Australian gas market and public opinion regarding the problem, let alone the best solution, is hugely divided.

Ai Group believes that the collective gas policy of Australian governments should ensure that prices rise by no more than necessary and that the transition to higher prices is as smooth as possible. There are tremendous gains to be made through export of gas, but the costs and unintended consequences of this development need to be considered and attended to.

The Study provides welcome insight into the situation in Eastern Gas Market, which is crucial to informing the policy debate. However, Ai Group would like to see greater consideration of how gas market developments will impact the wider economy, including gas-using industry. The Study does not address these impacts in any detail, and makes assumptions about the economic value of domestic gas use that would benefit from scrutiny. Decisions on some policy responses should not be made without a fuller understanding of their economic context and consequences.

Ai Group welcomes the Government’s steps to consult gas users in developing its agenda. Domestic industry should remain at the centre of the policy debate and the development of policy responses. To that end, we, in conjunction with several other industry associations, have commissioned a report to explore the national economic consequences of changes in gas price and supply in Australia to 2025. This will include detailed economic modelling of the wider impacts of representative gas price scenarios drawn from the Government’s own recent Study, as well as projections for Western Australian gas prices drawn from the Independent Market Operator’s recent Gas Statement of Opportunities. We will make this work available to the Government as soon as possible.

The current and proposed reform agenda canvassed by the Study is broad and largely sensible. Of the options summarised in Box 7.1 of the Study, almost all would be positive. However, there are limits on the breadth of an agenda that governments can pursue effectively. Beyond completing existing reforms already committed to, including the Wallumbilla hub, we highlight the following elements as priorities for a forward reform agenda:

- Pro-competitive measures in the gas market, including a review of competition, better administration of gas titles – including enforcement of ‘use it or lose it’ provisions for gas tenements – and further work to enhance pipeline capacity trading;
- Encouraging greater gas production by removing unnecessary regulatory restrictions on new production – rolling back risk adverse policies in favour of those based on real science; and
- Improved information on CSG delivery risks.

Production requires further comment. However there are also two further areas not adequately covered in the Study that warrant consideration, and should be included in the policy principles the Study suggests. One relates to the management of systemic risks, and the other relates to considering and responding appropriately to the wider impacts of gas market developments on users, the economy and policy. Both are discussed below.

Encouraging production

Ai Group has noted with concern that although Australia’s overall gas resources are amongst the largest in the world, for a variety of reasons the pace and quantity with which those resources have come to market has been slower than anticipated. However with export contracts already signed and liquefaction facilities soon to come on line in Queensland, a vast new source of demand will have to be met regardless of the pace of CSG development. As the Report notes, even small deviations from expected development can result in “significant quantities of gas being sourced from traditional domestic supply”. The potential for a supply squeeze and for price hikes even above export parity would have extremely serious impacts on gas-intensive industry and the wider economy.

To minimise constriction of supply Ai Group continues to urge all levels of government to speedily eliminate excessive regulatory barriers to gas production. Ai Group has repeatedly urged a calm approach to CSG regulation that balances the needs of a secure gas supply and with concerns over environmental and social impact. Of particular concern are the blanket bans on CSG across wide areas of NSW and the moratorium on hydraulic fracturing in Victoria. Both NSW and Victoria have substantial potential for unconventional gas production, yet currently NSW remains almost entirely dependent on inter-state gas supply – which is being radically reshaped by the LNG boom – while the dominance of existing conventional gas producers in Victoria means gas users face prices much closer to export parity than would be predicted by an efficient market model. Regulatory barriers are stifling the increased exploration and production from unconventional gas that we need to shore up domestic supply in the face of rapidly expanding export demand.

After an extensive 2013 study that accepted over 200 submissions the office of the NSW Chief Scientist has concluded:

From a technical and scientific standpoint, many challenges and risks associated with CSG are not dissimilar to those encountered in other energy and resource production, and water extraction and treatment. Some challenges are well defined and can be effectively managed through high standards of engineering and rigorous monitoring and supervision of operations.

Victoria has launched a two-year consultative process to consider how to proceed on gas. NSW has confirmed the exclusion of CSG production and exploration from much of the state. Ai Group believes that these bans do not have a basis in science and should be reversed as soon as possible. A responsive regulatory regime guided by impartial scientific and technical advice is far better placed to manage the risks and rewards of the industry than a blunt prohibition.

Systemic risk and a national interest test

Ai Group sees a clear need for careful national assessment of, and capacity to respond to, systemic risks related to gas. The Study identifies fairly clearly that the potential for a mismatch between the rate of CSG development and the commencement of LNG exports would have a dramatic effect on supply and price for domestic customers. These risks are unlikely to be adequately taken into account by individual project developers, and they carry the potential for widespread economic disruption and harm. Governments have an obligation to exercise vigilance – just as they monitor the stability of the financial system. This is the main reason to consider a national interest test for new LNG export capacity.

The Study considers a national interest test very briefly, principally as a variation on a reservation policy and aimed at ensuring that domestic prices remain below export parity. This is inadequate. Ai Group does not propose any form of reservation; as many have noted, retrospective reservation would carry severe sovereign risk issues, while forward-looking reservation could be inflexible and would not be effective for many years, if ever, depending on design. The national interest test we propose is quite different in intent and effect.

The current situation gas users confront, with risks highlighted in the Study that gas prices will spike above international levels amid extended supply tightness, has arisen in part because the current expansion of the LNG sector took place without adequate scrutiny. Each project has been subject to extensive assessments of environmental impact, and in some cases to consideration by the Foreign Investment Review Board. But there was no consideration of the individual and cumulative impacts of these specific projects on gas supply, gas users and the wider economy. Instead a COAG process in 2006-07 took a high-level view of possible impacts of a hypothetical LNG expansion much smaller than what has transpired, without delving into the detail of supply, timing or wider ramifications.

In light of current risks and experience this lack of scrutiny should not be repeated. A national interest assessment of new LNG export proposals would provide an opportunity to test confidence in the availability of gas production – as opposed to reserves – associated with the project, and the overall implications for the domestic market and domestic users. Such a process would not prevent the development of a flourishing LNG export sector, as demonstrated by the experience of the United States and Canada, which impose variations on this assessment. Instead it would help ensure to de-risk that development and ensure domestic and export gas uses can thrive together. The requirements of a national interest test should be designed to ensure there was no additional time involved in approvals processes and that additional regulatory costs were minimised. Ai Group has already provided specific, practical proposals for implementing such a test in Australia. These are reproduced at the **Attachment**.

Gas and energy efficiency

Even if gas production and infrastructure comes online smoothly and matches well with LNG demand, domestic gas consumers will still find themselves paying prices substantially above historic levels in the near future. At a time when most are also under acute pressure from other sources, including the high Australian dollar and intense overseas competition, there is very little scope to pass on the additional costs. This risks undermining investment and reinvestment in Australian industry.

Gas users will need to make rapid, major adjustments to maintain their competitiveness. For some this will involve fuel switching to grid electricity, coal or other energy sources. For others, particularly those who use gas as a feedstock, this will be impractical or unaffordable. Many companies will look to energy efficiency options to prevent price increases turning into increases in final costs. Government should consider how to facilitate this efficiency imperative, including through provision of information and advice to smaller and medium-sized energy users and by ensuring coverage of gas that any support or financial incentives provided for energy efficiency. Any efficiency policies adopted should be subject to a careful cost benefit analysis and should not increase net energy costs for trade exposed industries.

The steep escalation in gas prices will effectively remove gas as a lower-cost and lower-emissions source of energy for many businesses. In particular, industrial cogeneration systems without existing long-term low-priced gas supply contracts are unlikely to be viable. Ai Group is aware of businesses who have indefinitely suspended plans to adopt gas, or who currently use gas and are considering converting back to grid electricity or coal. In the circumstances this is a rational business response, but government should be aware of the implications for Australia's emissions reduction goals and related policies.

Ai Group looks forward to continuing to work with the Government throughout the White Paper Process,.

Yours sincerely,

A handwritten signature in blue ink that reads "Innes Willox". The signature is written in a cursive style and is underlined with a single blue horizontal line.

Innes Willox
Chief Executive

Recommendations for a national interest test

1. Australia's tremendous conventional and unconventional gas resources represent important opportunities both for export and domestic use. These uses should be complementary to maximise Australian prosperity.
2. While the gas market faces serious issues of supply tightness and price increase, we do not recommend policies that would reserve for domestic use gas already contracted for export.
3. To support the productive coexistence of gas exports and domestic consumption, we recommend a national economic approval process for new gas export capacity, whether onshore or offshore, similar to existing processes in Canada and the United States.
 - a. This national approval process should not duplicate existing planning and environmental approvals.
 - b. The process should approve new liquefied natural gas export facilities, and significantly expanded capacity at existing facilities, where it is established that:
 - i. Approval would leave adequate gas supply for domestic requirements in relevant Australian markets over the life of the facility;
 - ii. Approval is in the national interest, taking account of economic, strategic and social impacts of the proposed expansion; and
 - iii. Opportunities for and net benefits of parallel supply to domestic and export markets have been adequately considered by proponents.
 - c. The process should involve public submissions and advice from the States as well as from the Federal Treasury and the Departments of Energy and Industry.
 - d. This material should be considered by an independent board including members with broad expertise and experience in gas production, marketing and industrial use, as well as broader economic policy.
 - e. The board should make recommendations for final decision by the Federal Treasurer. Recommendations of the Board and supporting reasons should be made public without compromising any commercially sensitive information.
 - f. A final decision should be required within six months of application, and the process should be able to precede, follow, or run in parallel with other processes such as environmental approvals. A rejected application should be able to be reworked and reconsidered.
 - g. The process should not apply to projects on which a final investment decision had been made before 1 July 2013.
4. A national approach to this issue is strongly preferable, though recognising the physical separation of Eastern, Western and Northern gas markets. However, if a national approach is not possible in practice, then equivalent approval processes should be developed by the States until national harmonisation can be achieved.