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Department of Industry, Science and Resources

AI GROUP RESPONSE TO SECURING AUSTRALIA'S DOMESTIC GAS SUPPLY ISSUES PAPER

The Australian Industry Group (Ai Group) welcomes the chance to make a submission on the Securing Australia's Domestic Gas Supply issues paper (the Paper).

Ai Group is a peak national employer organisation representing traditional, innovative and emerging industry sectors. We have been acting on behalf of businesses across Australia for nearly 150 years. Ai Group is genuinely representative of Australian industry. Together with partner organisations we represent the interests of more than 60,000 businesses employing more than 1 million staff. Our members are small and large businesses in sectors including manufacturing, construction, engineering, transport & logistics, labour hire, mining services, the defence industry, civil airlines and ICT.

Our members include many industrial users of natural gas, who currently rely on it for process heat, electricity generation, or chemical feedstock. While all will need to contribute to the transition to net zero emissions in coming years, most likely through replacing natural gas via electrification, biogas or hydrogen, the availability and affordability of natural gas will be important to their viability for many years to come. And all businesses are impacted by the gas market for so long as gas powered generation plays an important role in reliability and price-setting in the electricity market.

In 2017 Ai Group played a leading role in bringing the facts of surging industrial gas prices and a scarcity of contractable gas to the attention of the former Government. Mid-size industrials were reporting then-extraordinary contract offers above \$20 per gigajoule, far above the \$8-12/GJ that had been thought to be a long term 'export parity' range, and even further above the pre-LNG average of \$3-4/GJ.

At that time it appeared that the price rises and difficulty for industrial gas users to obtain contract offers were attributable to an overcommitment by gas exporters and underperformance in their gas production. We pointed to the scope to use of the Commonwealth's power over trade and exports as a backstop to ensure local supply adequacy. But we expected that in a well-supplied global market in which much Eastern Australian gas had relatively high production costs it would be straightforward for suppliers to rebalance and meet their commitments and local needs through swaps.

We were broadly supportive of the Australian Domestic Gas Security Mechanism (ADGSM) as enacted by the former Government. While it looked quite complex and would have been slow to use, we thought that it would be effective in responding to the problems of the time. And indeed the gas exporters did rearrange supply and make undertakings through the initial Heads of Agreement. While the ADGSM was never triggered, industrial gas contract scarcity and extreme price offers eased.

However, today's circumstances are quite different. The Russian invasion of Ukraine; Europe's decision to move as fast as possible to end its reliance on Russian energy, most importantly natural gas; and Russia's moves to pressure Europe into accepting Ukraine's subjugation by cutting off gas supply before Europe is ready; these factors mean a tight global gas market and high global gas prices, both today and for years to come.

Eastern Australian energy markets, households and businesses are extremely exposed to those international pressures because of the significant roles gas plays today, because Eastern LNG

exports are three times the size of Eastern domestic gas consumption, and because there are no barriers or safeguards to moderate international pressures – except the ADGSM. But the ADGSM is not fit for purpose in current circumstances.

There are supply scarcity concerns in 2023 and beyond, highlighted by the ACCC in their recent gas market inquiry interim report, and triggering the existing ADGSM will be considered. Ai Group has stated that if Australian gas markets face absolute scarcity, the Government will need to be able to trigger export controls as a last resort. However we also recognise that this is a difficult step amidst a global energy crisis. At the margin, forcing lower gas exports will contribute to the supply and price difficulties that our trading partners and allies are facing as a result of Russian aggression. The less Australia needs to rely on export controls, the better.

The ADGSM's status as an important last resort makes it worrying that the existing mechanism is so slow and cumbersome, and any impacts so unevenly spread among gas exporters, that it is very hard to use effectively. In addition the current ADGSM design does not directly address affordability of gas supply, especially when unaffordability may be driven by international pressures rather than domestic supply.

Ai Group therefore welcomes the timely review by the Australian Government of the ADGSM's design.

Principles

The Paper proposes seven principles to guide ADGSM reform, and presumably further Government gas policy development. These include supply adequacy, downward pressure on price, supporting global energy security, respecting investment and trade relationships, supporting energy transition, enhancing transparency and minimising implementation costs.

Broadly these principles are appropriate, with two important provisos.

First, “downward pressure on gas prices” as a headline principle is both vaguer and narrower than the preferable concept of “affordability of gas costs”. It is vague because any infinitesimal quantity of ‘downward pressure’ can coexist with extremely bad outcomes for energy users. And it is narrow because the outcome for users is the product of both price and quantity used. Policy should pay attention to both price and usage, and above all to effective outcomes for users rather than more abstract inputs or dissociated elements of the marketplace.

Second, policymaking needs to more clearly consider demand in relation to the achievement of all outcomes sought – affordability, reliability, emissions and contributions to global energy security and Australian opportunity. The traditional portfolio demarcation, where gas supply sits with Resources and gas demand sits with Energy, is dysfunctional and unhelpful. Demand is at least as important as supply and both need to be fully incorporated into a unified strategy. Reductions in gas demand through efficiency, electrification and fuel switching to biogas or hydrogen can reduce the impact of high prices in the near term, help prevent supply shortfalls in the medium term, and help achieve our long term climate objectives. Many of Ai Group's leading gas-using members are planning for their long term transition to end the use of fossil gas altogether, though the practical pathways and economic considerations vary widely between different contexts. Despite the potential role of carbon capture and storage, it is clear that fossil gas use in Australia and around the world will need to deeply contract over the next three decades to achieve the climate stabilisation objectives of the Paris Agreement.

Activation at short notice

Scope for faster ADGSM activation is essential to be able to react to events in a timely way. The current stepped process entails a lag of up to 15 months, and perhaps more, between the occurrence of dangerous circumstances and the potential response. This arises because of the need for a Ministerial notification of the potential for a decision no later than the 1st of October in the year before a limit comes into effect. A sudden change in circumstances could easily arise after this

timeframe. Indeed, this year extreme price rises and supply constraints arose in May, but the earliest the ADGSM could be triggered was eight months later.

Greater flexibility on the timing of a trigger decision should be complemented by continuation of the flexibility to end a trigger declaration if the circumstances change sufficiently in the judgment of the responsible Minister, with at least 1 month's notice.

Instead the rules should allow for immediate action if the circumstances demand it. The rules should commit the responsible Minister to seeking advice from energy market and competition bodies before making a decision to trigger, and should encourage but not require at least 1 month's public notice of an intention to make a decision. Where a decision is taken with less than that notice, the rules should require that it be reviewed within 3 months.

Price based activation

A price-based trigger is very relevant to the deep concern felt by gas users of all sorts at the prospect of extreme price rises that challenge the affordability of energy for households and industry. However a price trigger also raises several difficult issues.

Arguably a view of price is already implicitly embedded in the existing trigger. From the abstract perspective of an energy market model there can never be a 'supply shortfall' per se, since in the presence of supply constraints prices will rise as far as they must to destroy enough demand to balance what is left of the market. The existing ADGSM assessment process compares expected supply with a forecast of demand based on an implicit price expectation - export parity pricing.

Any choice on whether to cement export parity pricing, or to depart from it, is fraught. The rational allocation of resources, realisation of full value from Australia's endowments, and efficient use of energy would seem to be maximised by the development of a single internationally consistent price for natural gas. However, there are complicating factors.

Firstly there is no single internationally consistent price for natural gas, but multiple geographically distinct markets with different pricing patterns, loosely connected by the growth of trade in LNG. LNG is mostly sold under confidential long-term contracts, sometimes linked to oil prices. Legacy contracts and industrial policy shape the prices paid by many international gas users more than immediate movements in the smaller but more visible spot markets. Thus the full exposure of local industry to 'international' prices, and even more so to spot prices, can lead to disadvantage and the loss of industrial capacity that would be viable in a fully level global gas market, or in a net zero emissions global economy that is likely to be much less gas-reliant.

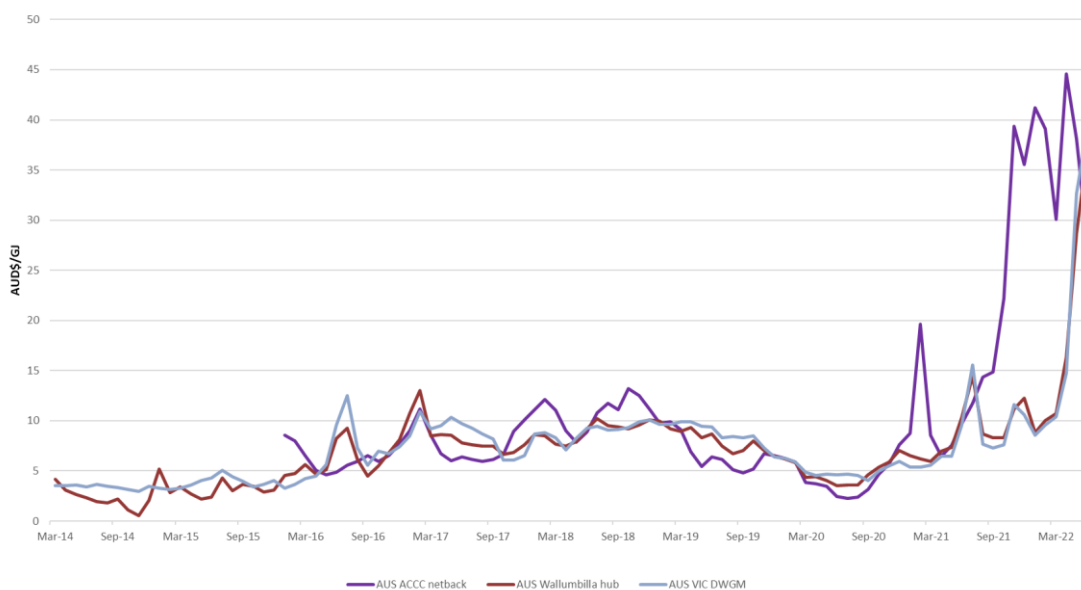
Secondly it is hard to see how current arrangements achieve full value from Australia's resource endowments. Gas resources are subject to the Petroleum Resource Rent Tax (PRRT), but the large project development and exploration expenses involved and the very high uplift rate used for carrying these expenses forward mean that very little tax is paid on these projects. The 2017 Callaghan Review of PRRT considered that the uplift rate should be reviewed for new projects, but that existing projects would eventually pay significant tax and should in this respect be left alone. That Review did not appear to pay any attention to the potential for future oil and gas prices and export volumes to be depressed by global action on climate change. Now, with all of Australia's major trading partners committed to net zero emissions in coming decades, it is plausible that current arrangements will see the exhaustion of PRRT deductions around the time that taxable rents start to decline. Should that occur, Australia's revenue benefits from its waves of LNG development will have been largely limited to company tax and royalties.

Thirdly, full exposure to volatile spot markets for LNG has serious consequences for Australians. These include not just the impact on direct gas users in industry and households, but on all electricity users through the significant role that gas currently plays in electricity price setting, and on consumers of gas-intensive products. Many nations exposed to recent price surges driven by the invasion of Ukraine are considering or implementing interventions to seek to shield energy users

from excessive impacts.

However disconnecting local gas prices from international prices through a price trigger would be complex. The choice of metric is important; the ACCC's netback price index is an obvious candidate, but most gas is not bought on spot and contract price data is opaque to most observers and lags even for the ACCC. Importantly, average spot prices in Eastern Australian markets have very often been at variance with the ACCC netback metric.

Over the 79 months of netback data, monthly average prices at the Wallumbilla Hub have been above netback on 40 occasions, and in the Victorian Declared Wholesale Gas Market monthly average prices have been above netback on 35 occasions. However all three metrics have moved broadly in line with each other over most of this period.



A price trigger might thus need a lag or averaging element to avoid being imposed very frequently due to common volatility.

There is also a challenge in translating a price trigger into a quantitative limit on exports. The existing supply adequacy trigger has a more obvious relationship to an export limit: the limit is expected exports minus the difference between total expected supply and total expected demand. This seemingly straightforward calculation does involve a reliance on modelled estimates. But the choice of a limit to achieve a different price outcome is even more reliant on models that are sure to be imperfect and contested.

On balance, given these complexities and the need to minimise disruptions to supply to our allies and trade partners, Ai Group considers that the best way to secure the interests of Australians and energy users is not to adopt a hard price trigger. The existing supply adequacy trigger should be complemented by other measures to help energy users across energy management, energy supply and the tax and transfer systems:

- Businesses and households can become less exposed to gas prices through gas efficiency and transition to electrification, biogas and hydrogen. Technical support, finance and regulatory measures such as standards for new construction and rental properties will all be important. Results may take time to deliver.
- Forward-looking gas reservation may have a role at the national level; while it can be complex to design, WA's model has been clearly compatible with both strong supply development and good consumer outcomes. At this point a prospective reservation will take some years to have a market-wide impact.
- Financial support will be needed, at least in the near term, for vulnerable energy users. This includes low-income and otherwise vulnerable households, and also businesses that are

gas-intensive, exposed to high prices and unable to pass costs on.

- To offset the costs of financial support and investments in efficiency and transition it is important to achieve greater value from Australia's gas exports. The Government should urgently enact stricter settings, particularly uplift rates, for the PRRT. Some or all of these stricter settings could be waived for existing developments where they are already directly subject to a domestic gas reservation obligation. Adjustments to this existing long-established tax are entirely compatible with the Government's election commitments.

Incentives for domestic supply

The Paper asks if there is a need for encouraging or requiring supply that cannot be exported to be offered to the domestic market. It is not clear that a special further incentive is needed to encourage local supply, especially if any shortfall-related limits are broadly spread - an exporter will already desire to bring otherwise-unsellable gas to the local market at any price on which they can make a return.

An extra incentive might encourage more production in total, so as to be able both to offer gas locally and export more. However it's not clear this could make much difference during the relatively short life of an imposed limit. The existence of a supply adequacy-based ADGSM itself provides some encouragement to invest sufficiently to avoid the trigger.

Improving administration of export permits

The Paper raises the potential to change the current Total Market Security Obligation (TMSO) arrangements. The calculation and apportionment of the TMSO is complex and makes it likely that invoking the ADGSM would severely impact one exporter, making it less likely the ADGSM will be triggered even if otherwise warranted.

It is not clear why there should be any reference to 'net contribution to the domestic market' at all. Defining 'own gas' and 'export compatible gas' is fraught and its relevance is contestable.

It would make much more sense for the ADGSM, when triggered, to establish a system of tradable export permits up to the quantitative limit consistent with the security goal, and allocated to exporters based on their share of nameplate export capacity in the relevant market. Exporters can then make arrangements among themselves to ensure that commitments are met.

There is no need to directly exempt contracted gas from the ADGSM export permits, but the extent of long-standing contractual obligations can be taken into account in setting the applicable market-wide export limit.

State and territory measures to increase supply

It is not clear that much more is likely to be practical to encourage gas production.

- NSW unconventional gas at Narrabri is likely to be developed but no other known resources seem likely to be accepted by communities or any side of politics.
- Potential NSW conventional offshore gas exploration has been widely rejected by all sides of politics and levels of government.
- Victorian onshore conventional gas is now open to exploration and development, though the potential volumes are quite modest (perhaps 15 PJ/yr if the resource is as estimated by the Victorian Geological Survey, and is entirely developed and produced over 30 years).
- Victorian unconventional gas is strongly resisted by the community and all sides of politics.
- Other states and territories are very open to development.

State, territory and federal policies on demand-side efficiency, electrification and the supply and use of renewable gases will need to ramp up considerably, however. These steps towards gas demand

reduction are already key to the expected 2030 gas market balance in the 2022 Gas Statement of Opportunities, but existing policy is far short of what would be needed to deliver this rate of change.

For any questions in relation to this submission, please contact Ai Group Director of Climate Change and Energy Tennant Reed (tennant.reed@aigroup.com.au, 0418 337 930).

Sincerely yours,

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