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AI GROUP SUBMISSION ON THE MANDATORY GAS CODE OF CONDUCT

The Australian Industry Group (Ai Group) welcomes the chance to make a submission on the Mandatory Gas Code of Conduct (Mandatory Code).

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 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. Many other members make use of goods and services for which gas is an important input. 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.

The Mandatory Code of Conduct includes the Government's proposal for an extraordinary intervention in the setting of the relevant prices. There are significant known and unknown risks associated with such an intervention. It is critical that these risks should be fully understood and mitigated. A key mitigant of the risks would be a clear articulation of the triggers for the lifting of the RPP and legislative provisions governing its removal.

It is essential that the benefits of Government's energy price interventions, including the emergency price cap, the Mandatory Code and the RPP, ultimately flow through to all users of natural gas, whether they are wholesale buyers, retail customers or users of gas-intensive products. This submission considers the context of the energy crisis; the policy considerations; the options for the implementation of the Code; and the need for clear principles to guide interventions of this sort.

The context of crisis

Global energy markets have been in a crisis, and Eastern Australian electricity and gas markets have been caught up in it. A large and impactful response is essential, despite the significant shortcoming and risks involved in all the available near-term response options. Ai Group and our members across industry would like to see national policy succeed in moderating the costs of the immediate crisis and enacting a long term strategy that will ensure Australian businesses and households can access energy that is affordable, sufficiently reliable and secure, and clean.

The illegal invasion of Ukraine by Russia in February 2022 has had immense human, strategic and economic consequences. One was to destroy the energy trade, particularly in natural gas, between Russia and Europe. Russia has sought to use the reduction in gas supply as a tool of diplomatic and

economic pressure. The European Union is no longer willing to tolerate its former energy dependence on Russia. Key pipelines have been sabotaged by persons unknown. European imports of Russian gas are down more than 80% on their preinvasion levels and are likely to reach zero before long.

Europe's strategy to get off Russian gas has many components, including energy conservation in the near term and a faster transition to renewables, electrification, biogas, hydrogen and efficiency over the course of this decade. But the biggest single component in the near term has been expanded imports of Liquefied Natural Gas from all available non-Russian sources. While the United States, Qatar and other gas-rich jurisdictions are planning for LNG export capacity, in the near term supply is not particularly flexible.

The gas Russia is no longer able to sell to Europe is equivalent in volume to a quarter of the pre-invasion global LNG supply. Russia is unable to redirect much of this gas to other customers in the short term and would need substantial new LNG liquefaction capacity or transcontinental pipelines to fully redirect to friendly or neutral markets. That will take at least several years to achieve.

The combination of additional LNG demand and relatively inflexible supply saw a surge in global LNG prices in 2022, and a flow-on rise in prices in all energy systems connected to the LNG market. Eastern Australian was no exception, and from March to December 2022 indicators for electricity and gas prices facing energy users over the next few years reached deeply concerning highs.

In the last couple of months global LNG prices have dipped as Europe's various measures proved sufficient to weather a mild winter largely without Russian energy. Prices remain very high, and it is unlikely they will normalise within the next couple of years. Indeed, it is quite plausible that China's emergence from Covid Zero puts additional pressure on global gas demand, or that a hot northern summer or cold 2023-24 winter does likewise.

Policy considerations

Ai Group has been consistent over the past year in warning of the darkening situation, highlighting the need for action, and acknowledging the shortcoming and risks of all the available response options. These are worth reviewing, despite the fact that the Government has settled on emergency price caps for gas and for coal used in electricity generation, and on the Mandatory Gas Code of Conduct.

Broadly the imaginable options included more supply; export limitations; price controls; consumption subsidies; faster energy transition; or doing nothing.

More supply of natural gas is a logical solution but in practice is irrelevant for reasons of scale and timing. On scale, the energy affordability crisis has not been caused by a lack of gas within Australia but by a large imbalance in global markets equivalent to around a quarter of preinvasion global LNG trade. Australian gas production would need to more than double to fill that gap alone. On timing, genuinely new production and pipelines beyond what is already in train would take at least several years to be delivered. As important as supply is for the long term balance of our gas market, new supply simply cannot address the immediate crisis.

Export limitations have been widely discussed. Australia's gas exports bring large benefits but the framework under which they take place in Eastern Australia leaves the local market heavily exposed to international pressures, unlike Western Australia. However the idea of limitations on gas exports is extremely unwelcome to our trade partners and security allies, especially in the context of a global energy crisis. It also raises questions for Australia's ambitions as a clean energy exporter. Emergency export control powers such as the ADGSM have their place, but an export-limitation response to the affordability crisis has obvious drawbacks.

Price controls have been practiced during past wartime emergencies but neither the design nor the implementation of such measures are unfamiliar to current policy makers. Devising and administering price controls is complex and raises difficult issues, including the adequacy of

regulatory data and analysis, the impact on efficient investment, price impacts elsewhere in the economy and distortions to resource allocation, and the limits of intervention.

Consumption subsidies risk unintended and perverse consequences, such as encouraging higher consumption of scarce goods and higher emissions. They may also be inflationary and would certainly be costly to the Budget. Prior to the Government's intervention, Ai Group calculated that fully addressing the cost increases facing the most vulnerable 10% of energy users (while doing nothing for anyone else) would cost between $5 billion and $9 billion over the next three years. Obvious measures to offset these costs would include scaling back the generous deductions available under the Petroleum Resources Rent Tax or imposing new windfall profit taxes. Such measures would certainly be controversial with gas producers.

Fast energy transition can reduce the impact of gas prices through greater efficiency in gas use and greater reliance on renewable electricity, biogas or hydrogen. However the timeframes involved in deploying major new clean energy infrastructure or widespread building upgrades are significant. While it is important to start these measures as soon as possible to meet our medium- and long-term needs, we should not expect that they will deliver broad relief from immediate energy price pressures.

Finally, doing nothing would have seen Australian energy users exposed to internationally-driven energy cost increases somewhere between painful and crippling. There were no uncomplicatedly good response options, but inaction was obviously unacceptable.

Therefore while this submission grapples with complications and difficulties in the Government's chosen option of price regulation, Ai Group recognises that there is no obviously best option. While we should plan to emerge from the need for crisis measures as soon as possible, and pursue an effective long term energy strategy, we must acknowledge and deal with the immediate crisis too.

Responses to selected consultation questions

Are the obligations outlined in the voluntary code, if made mandatory, adequate to address bargaining power imbalances between gas suppliers and purchasers in the negotiation of gas supply contracts?

Considerable work was done by gas users and gas suppliers on the existing Voluntary Code. That Code includes a range of procedural obligations directed at good faith, information provision and opportunity to properly consider offers. Those obligations were positive in their original context and adopting and adapting them for the Mandatory Code is sensible and should be relatively straightforward.

It is important to emphasise that while there have been concerns expressed from time to time over the years about negotiating tactics, 'bad behaviour' is not the major cause either of long-standing disputes about Eastern Australian gas prices nor of the extraordinary surge in those prices. The main factor has been the opportunity cost of not exporting gas, and different views about the role this should play in local price formation. This factor was not able to be addressed in any way through the Voluntary Code.

Should the Code be limited to wholesale contracts where the supplier is a gas producer, or be expanded to include contracts offered by other market participants, such as retailers? This need not broaden the application of the reasonable pricing provision

It is essential that the benefits of the Mandatory Code ultimately flow to all end users of gas, whether they are direct participants in the wholesale market or are retail customers. Very few gas users directly participate in the wholesale market. Their interests are very important. There should also be attention to the commercial impacts on end users of goods and services for which gas is a major input.

Therefore the Mandatory Code must at least cover sales to retailers as *buyers*.

Extending obligations to retailers as gas *sellers* is worth considering, but is just one of at least three options to assist retail customers:

- If retail competition is effective, retailers should be strongly motivated to offer customers prices that reflect the extent to which retailers' own costs of gas acquisition fall as a result of the Mandatory Code. On the other hand, the collapse of some energy retailers amidst the financial pressures of 2022 may have impacted competition, and the current freeze on new gas contracting by upstream suppliers has limited the ability of retailers to offer new contracts to commercial and industrial customers. ACCC monitoring of retail outcomes in the gas market is crucial for confidence in a competition-led approach.
- A Gas Retailer Code would likely need very substantial adaptation from a Code focussed on sales by gas producers. The factors relevant to retail price stacks are different from those applying to first sale by a producer, and retail customers are quite diverse – procedural obligations would also need to be substantially different. The arbitration framework would probably not be fit for purpose for a large number of smaller customers. At a minimum, significant time would be needed to develop a Retail Code.
- The so-called 'Big Stick' changes to the *Competition and Consumer Act* made through the *Treasury Laws Amendment (Prohibiting Energy Market Misconduct) Act 2019* could be extended from electricity to gas. These provided, among other things, for penalties and remedies if electricity retailers did not make reasonable adjustments to their offered prices to reflect sustained and substantial reductions in their underlying cost of procuring electricity. We note that Ai Group was not supportive of the extreme power within these amendments for forced divestiture of assets. An extension of the 'Big Stick' would require significant further consultation and design.

On balance, we suggest that in the first instance the Government rely on retail competition accompanied by continued ACCC monitoring of retail market outcomes and energy user feedback. Monitoring could also usefully be extended, in cooperation with the ABS, to assess any impacts on the selling prices for energy intensive products; this is complex, as industries differ widely in their anticipated scope to pass on energy cost increases given the extent of their competitors' own exposure to energy market movements. The Government should state its readiness to develop one of the other options if retail gas prices do not soon reflect the impact of the wholesale Code on retailers' actual costs of supply.

It is important to recognise that, even more so than large gas users, gas retailers have a portfolio of forward gas supply contracts to secure their needs and manage their financial risks. That portfolio blunts and delays the impact both of upticks in wholesale gas prices and of reductions. That will dilute, but not eliminate, the benefits that we should expect to see flow through to retail gas customers over time.

How could the binding arbitration process be designed to ensure resolution in an efficient and cost effective manner, particularly with regard to reasonable pricing?

The most important factor in efficient dispute resolution is likely to be the clarity and suitability of guidance from the ACCC and the Arbiter on the reference price (or prices) under the Reasonable Pricing Provision (RPP). Nobody would like to see a substantial portion of gas supply negotiations lead to arbitration. This can be avoided once market participants have a clear understanding of:

- The level of the reference price at the time of negotiations;
- Whether there is one reference point across the interconnected Eastern market, or more than one (such as for different regions with different marginal sources of supply or transport costs);

- The physical basis of the reference point: what is the specific marginal supply concerned, where is it and how would it get to a hypothetical customer?
- The treatment of relevant factors that will enable a broad reference price to be applied to the specific context of an individual negotiation; for instance contract duration, the level of flexibility in supply volumes, transport costs and so on. These factors might lead to a range of reasonable prices that extend above and below the reference price.

The final point may be the most contentious. There is in principle no difficulty with the application of a reference price in contract negotiations. For instance, since the commencement of LNG exports from Eastern Australia linked our market to markets overseas, many local supply contracts have involved a reference to international price metrics such as Brent Crude, modified by other contract terms. The difficulty arises in this case in the potential that modifying factors might be used not to reflect the value of these factors to the parties, but to defeat the intention of the RPP.

The ACCC has recently confronted the same risk in the context of the Emergency Price Cap and has provided initial advice on how it will evaluate relevant terms. Iterating on this approach will be helpful in the context of the Mandatory Code, though we note that most gas suppliers are currently claiming – albeit increasingly implausibly – that they still face too much uncertainty to make 2023 offers despite the ACCC guidance.

In addition to ACCC guidance, it would be helpful for the Code Arbiter to make available some public indications of the sorts of conclusions they reach in evaluating price-modifying terms and factors. Neither buyers nor sellers are likely to be enthusiastic about publishing sensitive commercial information. Nevertheless if there is any scope to publish de-identified information – such as the range of prices assessed as reasonable, or the impact of factors like distance or flexibility on reasonable prices – that would likely reduce the level of disputation.

On what basis should an arbitrator be able to make a determination on price?

Two key elements of an RPP are the identification of the marginal source of new supply, and the assessment of the reasonable return that would be needed to unlock that supply given the risk profile of gas exploration and development.

The marginal source of new supply may present more theoretical difficulties than practical ones. Assembling a list of reserves and their associated volumes and production costs is, if not straightforward, at least already done by consultancies to whose work ACCC has access. Comparing this list to demand projections and identifying the high end of the least expensive mix of resources required to keep the market in balance is simple in concept. Demand projections and the actual potential to develop supply both have uncertainties attached, of course. In practice, however, despite these uncertainties any plausible option for the marginal source of domestic supply is likely to have associated costs that are significant by historic standards and which would be at least viable, if not highly profitable, for existing production.

Aspects of the marginal source do need particular focus. One is that location matters. There are potentially relevant sources of supply across the Eastern market, from Queensland CSG to Narrabri in NSW to onshore conventional gas in Victoria to unconventional gas in the NT. A single reference price may be taken to imply that the reasonable price for a given transaction depends in part on the buyer's pipeline costs to bring gas from that reference location, regardless of where the specific gas they are negotiating for comes from. That is not unreasonable, but therefore these transport costs to expected customers need to form part of the least-cost supply stack from which a marginal source is nominated.

A second critical factor is the potential that later this decade the marginal source of new gas supply in Eastern Australia may be LNG imports. Several LNG import terminals have been proposed, and one is currently under construction (though with insufficient firm demand so far for full confidence that it will actually operate). The 2022 Gas Statement of Opportunities modelling scenarios suggested

substantial dependence on LNG imports by 2030, while the recent ACCC gas market monitoring update suggested that LNG imports were one of the most significant options available to fill the emerging gap later this decade between expected supply and demand.

While the RPP should not be needed forever (see discussion below), if dependence on LNG imports emerges during its lifetime the effect could be that imports become the marginal source of supply. If that came about, the reasonable price reference point would be even higher than the opportunity cost of not exporting. This would defeat the Government's policy intention that prices for the duration of the RPP reflect the marginal cost of local production plus a reasonable return.

There may be several ways to avoid such an outcome, the simplest being that the RPP should be defined by reference only to onshore production that is, or is proposed to be, directly connected to the Eastern market. This might mean that the reference price is set below the cost of some of the supply needed to meet demand, ie LNG. That could be resolved by agreement between buyers and sellers, since the Government has been clear that a price agreed between the parties is a reasonable one regardless of the reference price.

The assessment of the appropriate rate of return will naturally be highly contested. Ai Group acknowledges that gas exploration and development is indeed a risky activity where some projects make strong returns and some disappoint or simply fail to deliver any results at all. Risks are, if anything, increasing with the expectation that climate and energy transition drivers will see gas demand fall within the lifetime of new assets, albeit uncertainty about the rate of this decline and which assets will be most viable for longest. The expected returns needed to motivate investment are therefore certainly higher than in some other activities, though of course there are financial risks in all commercial activities.

Does the proposed model appropriately mitigate the risks associated with market intervention?

The imposition of an emergency cap and the RPP are dramatic and unusual steps taken in response to extraordinary and challenging circumstances. As important as it is to respond to those circumstances, the risks of action should also be understood and addressed. These include the potential for uncertainty, miscalculations and the fear of arbitrary action, which might discourage investment and increase costs; distortions and disputation in the labour market as employers and employees debate the flow through of energy price reductions; distortions and unintended consequences for other products and factors of production; unintended consequences for energy transition as the relative attractiveness of high-emissions energy is increased; and the political economy risk that resources are diverted from improving fundamental price drivers to battles over regulation. Over the course of this Submission, we have discussed most of these risks and mitigants that could be put in place.

As important as an emergency response is, Ai Group's members would not like to see the extraordinary intervention in the form of the RPP taken or continued without very good cause. Australia faces the potential for more global and regional conflicts and disasters which could have severe impacts on supply chains and key products. We will certainly also see lesser events with narrower impacts that might lead some to call for interventions. It is important for the Government to establish clear principles to govern price interventions and to articulate an exit strategy from the current intervention. Together these will help alleviate some of the risks listed above or at least the period over which the risks will need to be mitigated. With respect to energy transition, the Government's suite of energy and climate policies, particularly for supporting demand-side energy efficiency and transition, will become more important to the extent that gas prices are suppressed.

No general principle requires government intervention whenever the price of a good rises substantially above its cost of provision. For many goods high prices will be of little wider significance, and the price mechanism itself is typically capable of resolving the situation through encouraging higher supply or lower demand.

An emergency intervention to mitigate a severe price escalation may however be justified in some circumstances. Some factors that can be relevant to considerations include:

- Whether the price escalation reflects a very serious shock such as a war or catastrophe;
- Low or slow supply elasticity – whether the price escalation is unlikely to bring on a commensurate supply response in a relevant time period;
- Low or slow demand elasticity – whether the price escalation is unlikely to commensurately reduce demand in a relevant time period without unacceptable social or economic consequences; and
- Whether the good in question is of broad social and economic significance and (per demand elasticity) difficult to substitute in the short term.

Australia has seen natural disasters in recent years that caused severe rises in the prices of individual foodstuffs such as bananas or lettuce, but the diversity and substitutability of foodstuffs meant these had modest implications for consumers and the economy as a whole. By contrast natural gas, while fully substitutable in the very long term, is hard to substitute or do without in the short term and is a key input to a broad range of critical goods and essential services.

With respect to an exit strategy, provisions of the Mandatory Code concerning conduct, good faith and arbitration may be appropriate to continue indefinitely subject to assessment of their performance. By contrast the RPP will only be needed for a limited time. The Government should state a clear basis for when, and under what conditions, the RPP will be removed and what will follow it. The broad options may include:

1. Remove the RPP once global gas markets recover from the Ukraine shock (and as a consequence the first principle referred to above is no longer satisfied). The Government could articulate conditions for 'normalisation', such as North Asian LNG prices falling below a pre-war benchmark and remaining there for a minimum period.
2. Remove the RPP once circumstances have changed to the point where one or more of the other supply elasticity, demand elasticity or economic and social significance conditions outlined above are no longer met with respect to gas.
3. Remove the RPP once a longer term framework for Eastern Australian domestic gas markets is in place and effective. For instance, the previous Government consulted on whether to establish a prospective national gas reservation scheme comparable to the widely supported arrangements in WA.
4. Remove the RPP after a defined time period without defined conditions.

Whatever the Government's choice among these or other options, the exit strategy should be clear from the outset in order to minimise intervention risk and enable policy makers, energy users, energy suppliers and other stakeholders to prepare.

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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