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AI GROUP SUBMISSION ON THE MANDATORY GAS CODE OF CONDUCT CONSULTATION PAPER

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

Most of Ai Group's gas-using members do not participate in the wholesale market but buy their gas from energy retailers. The Government's proposed monitoring of retail outcomes by the ACCC, AER and other market bodies will be very important to ensure the expected moderation of wholesale gas prices flows through to retail customers, and is seen to do so. If retail customers do not see benefits within a reasonable time, the Government should urgently consider further action to remedy this.

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Overarching comments

The Mandatory Code and the wider energy policies of which it forms a part respond to extraordinary circumstances in global and local energy markets, particularly the invasion of Ukraine, which have had serious impacts on businesses and households. It is critical to address these immediate needs while ensuring our energy systems are able to meet our long term needs for affordable, reliable and secure energy as we transition to net zero emissions.

The Reasonable Pricing Provision (RPP) has been the focus of especially intense debate over just this question of short-term versus long-term needs. Gas suppliers argued that the previously flagged approach would undermine their future investment appetite, and certainly gas buyers have been unable to find offers for 2024 and beyond while the detail of the Code remained at issue.

The Government's revised proposal on pricing is a significant simplification and appears to provide gas suppliers with either a clear price cap over at least the next two years, operating similarly to the current one-year emergency cap; or an avenue to be exempted from the caps, either automatically for smaller producers or on application by larger producers that make binding commitments to supply the domestic market. There has not been much time to analyse the proposals, though we recognise the urgency of finalising the arrangements so that contracting for 2024 and beyond can resume. At this point we can simply say that we are hopeful that the proposed Code will be effective in moderating price outcomes over the next two years without undermining supply.

The proper arrangements beyond 2025 are much less clear. We are not attracted to emergency price controls that outlast the emergency. By contrast a more orderly restructuring of the domestic gas market to reduce its exposure to international volatility could be appropriate. Ai Group has been open to the idea of a national version of Western Australia's successful prospective gas reservation system. If the system of notional caps and operative exemptions works as the Government envisages, encouraging gas development by suppliers with no capacity to export and firm local supply commitments by exporters, it could achieve a similar result to WA by a different mechanism.

As it is too early to tell how the system will play out, we strongly support review of the Code by mid 2025, or earlier if there is a dramatic change in circumstances or obvious failure to achieve price and supply objectives. The continued appropriateness of the RPP, and its settings if it continues for a further period, must be considered in the light of its performance and the state of energy markets.

Responses to specific questions

Scope of application and conduct provisions

Good faith

- Do you have any comment on the proposed approach to 'good faith' in the exposure draft Code?
 - In the context of the Voluntary Code there was concern that the proviso "acting in accordance with legitimate commercial interests would not be considered a breach of good faith" would nullify price-related elements, though the latter ultimately could not be agreed. In the context of the Mandatory Code's Reasonable Pricing Provision, the mention of 'legitimate commercial interests' appears to be harmless.
 - The proposed approach to good faith is acceptable.
- Are the factors listed in the exposure draft Code appropriate to the gas industry?
 - Yes.
- Do you have any alternative or additional suggestions?
 - No.

EOIs

- Does the proposed approach strike the right balance between prescription and flexibility, and accommodate typical commercial processes?
 - The approach seems workable.
- Are the proposed EOI timeframes and information requirements suitable?
 - Yes.
- Are the circumstances specified in the Code that form the basis on which a producer may withdraw from an EOI process appropriate?
 - Yes.
- Is the exclusion of specific timelines and process steps for contracts under 12 months appropriate? Noting good faith provisions apply to contracts under 12 months, are any other protections required?
 - Yes. Prescriptive EOI requirements may do more harm than good when applied to very short-term contracting needs.
- Should the Code also prescribe a process and apply civil penalties to buyer-initiated EOIs?
 - Not at this time. Ensuring adequacy of supply to the domestic market is important, and one way to pursue this might be through obligations on suppliers in relation to buyer-initiated EOIs. Obligations on buyers in relation to their EOIs might also be considered to promote trust and fair dealing. However it does not appear these steps will be needed in the initial version of the Mandatory Code. Other elements of the Code, and in extremis the Australian Domestic Gas Security Mechanism, go to adequacy of supply. The universal good faith obligation goes to establishing trust. The performance of these elements should be considered at the first Review of the Mandatory Code. Buyer EOI-related obligations should be considered in detail at that time if necessary.
- Do you have any additional comments on what is proposed?
 - No.

Initial offers

- Are the proposed timeframes and information requirements for EOs and initial offers suitable?
 - Yes
- Are there any situations not already reflected in the Code in which a producer would, at the completion of an EO process (i.e. upon notification of successful EO applicants), not be in a position to make an initial offer to successful applicants?
 - No comment
- Do the flexibility provisions (i.e. to restart the initial offer clock or allow for extension of timeframes by mutual agreement) support typical commercial negotiations between parties at this stage?
 - Yes, particularly given the overarching good faith obligation.
- What circumstances not already reflected in the Code would result in a producer having to withdraw an initial offer?
 - No comment.
- Do you have any additional comments on what is proposed?
 - No.

Final offer

- Is the definition of a final offer and when this stage commences clear?
 - Yes.
- Are the proposed timeframes and information requirements for a final offer suitable?
 - Yes.
- Do the flexibility provisions (i.e. to restart the clock or allow for extension of timeframes by mutual agreement) support typical commercial negotiations between the parties at this stage?
 - Yes, particularly given the overarching good faith obligation.
- Are timing or other operational provisions necessary for the process following acceptance of a final offer and finalisation of a supply agreement?
 - No.
- Do you have any additional comments on what is proposed?
 - We have heard of some doubts raised by some gas suppliers as to whether the conduct provisions generally will apply to bilateral negotiations. Our reading of the draft Regulation is that bilateral negotiations are clearly covered by the rules relating to good faith, initial offer and final offer, whether or not there has been an open EO process. However it may be helpful for the Regulations and/or explanatory material to make a more explicit statement that bilateral negotiations otherwise within the scope of the Code are covered.

Pricing Framework

Application of the price cap

- Do you think the proposed approach will support the adequate supply of gas to the domestic market, at reasonable prices and on reasonable terms over the short and longer term, and how does this compare to the approach outlined in the December 2022 consultation paper?
 - The proposed approach is considerably simpler over the next few years than that

previously foreshadowed, which would have involved difficult questions including identification of the appropriate marginal sources of new gas supply in various parts of Australia and the appropriate returns on investment that were to be expected.

- The new approach does require some effort to fully understand. On its face it appears to effectively continue the existing \$12/GJ emergency price cap, with exemptions intended to ensure that higher-cost gas can be developed and contracted where necessary, and that large suppliers can make binding commitments to supply gas to the domestic market.
 - However in practice it seems likely that little or no gas will be directly subject to the price cap, with the exemptions framework doing most of the work to ensure that the local gas market is well supplied and not closely influenced by international gas markets.
 - Small domestically-oriented suppliers are exempted automatically. Large suppliers can be exempt if they make firm commitments to supply the local market that are sufficiently compelling to the Energy and Resources Ministers.
 - The motivation for large exporting suppliers to make commitments is to gain multi-year certainty about the pricing regime they face; and to avoid a situation where a shortfall in local supply leads to the invocation of the Australian Domestic Gas Security Mechanism (ADGSM), cutting spot exports and potentially threatening the credibility of their contracted supply.
 - As long as these motivations are sufficient, the result would be a market in which the gas needed by domestic customers cannot potentially be exported (as it is either lacks an export channel or is bindingly pre-committed to the local market). The opportunity cost of not exporting would not come into play in price setting, and achieved prices would reflect local supply and demand in a context of adequate supply. That would suggest price outcomes that are moderate, likely well below international levels at present and potentially below international levels on average if this system is sustained for the longer term.
 - If commitments by large suppliers are not forthcoming, the consequence would be that more gas sales are subject to the price cap and supply adequacy is achieved by a combination of exemptions for higher-cost suppliers and, in extremis, use of the ADGSM.
 - In this scenario we might expect a rush to contract by gas users, seeking agreements with suppliers covered by, and with costs below, the cap, in order not to be left in need of contracts with higher-cost producers.
 - We cannot be sure which scenario will ensue and the Government will need to be ready to respond to experience of this system as it operates.
 - To the extent that the proposed system continues past 2025, the price cap is relevant and its level is reviewed, the questions involved in the ACCC's price determinations are still difficult. What is "a workably competitive" market for gas? What is the best way to balance affordability and availability of gas?
 - The proposed regulations allow the ACCC to take account of the effect or expected effect of other related decisions or government policies. Expected Federal and State decisions and policies in relation to the transition of natural gas demand to other energy sources, including electricity and renewable gases, will be particularly important. To the extent that natural gas demand declines, supply adequacy is easier to achieve at a lower price level than otherwise.
 - This point also applies to potentially-difficult questions arising in the exemptions regime (see below). Measures to sustainably reduce demand make it easier to be confident that supply commitments will constrain price outcomes, and reduce the risk that lower prices will increase demand.
- Do you think the price cap set at \$12/GJ is appropriate to achieve this objective?

- In current circumstances of international energy turmoil and local concerns about the balance of gas markets, \$12/GJ seems like a workable cap. However, it is important to note that this remains a high price by any historic standard. It is at the upper end of the long-term export parity price range that was expected prior to the pandemic and the invasion of Ukraine. And it is well above the production costs of the vast bulk of gas in the market today.
- This is a price level that will, if it binds, further incentivise reductions in the use of natural gas. But it equally provides room for considerable discounting by most suppliers if, as gas users would hope, workable competition prevails.
- Do you have any comments on how price reviews are conducted?
 - The ACCC's role in these reviews will not be easy; the difficult questions of marginal supply and reasonable return are still embedded to a substantial extent in the matters which the ACCC must determine. However the exemption arrangements ease this determination to some degree. If they function as the Government hopes, they reduce the importance of the price cap as little or no gas will be covered by it. On the other hand if limited exemptions are granted and the price cap binds a significant share of gas supply, exemption provides a safety valve to ensure that producers with above-cap production costs can serve the market if the demand is there, without driving generally available gas prices higher.
- Do you have any other comments?
 - No.

Exemptions

- Are the criteria and process for qualifying for exemptions clearly defined? Are the factors Ministers may consider in granting an exemption appropriate?
 - We note the fact that an exemption applies to a producer (and potentially to its affiliates), rather than to a particular field or quantity of gas. A producer is either wholly subject to the price cap for all its output, or wholly exempt. We do not oppose this setting, but note that it is significant to understanding the operation of the proposal.
 - With respect to conditional exemptions, the criteria give the Ministers a wide degree of discretion and it would be helpful to have clearer guidance on how this will be exercised. This might be achieved within the Regulations or through statements of policy by the Ministers. Issues that would benefit from clarification include:
 - The characteristics of a 'workably competitive domestic market';
 - The parameters of a balance between affordability and availability;
 - The basis on which expected domestic demand will be determined, including explicit or implicit price range assumptions.
- Do you have any comments on what information should be published by the ACCC in relation to producers who are granted exemptions?
 - No.
- Do you have any other comments?
 - No.

Implementation and enforcement

Timing and transitional arrangements

- Do you see any issues with the proposal to apply the new pricing rules after the current price cap arrangements contained in the Competition and Consumer (Gas Market Emergency Price) Order 2022 (Price Order) expire in December 2023?
 - No. However the Ministers should move as quickly as possible to provide the further guidance referred to above on the interpretation of matters crucial to the conditional granting of exemptions.
- Should additional transitional arrangements be considered to ensure contract negotiations for new supply are not impacted?
 - No comment.
- Do you have any other comments?
 - No.

Reporting and record keeping

- Do you have any comments on the proposed reporting and record keeping requirements?
 - We have some concern about the commencement in January 2024 of publication by producers of information on planned EOIs and expected contractable volumes. With contracting for 2024 and beyond having been paused for the last six months, it is urgent to resume activity. The early availability of the envisaged information will put gas buyers in the best position to participate in contracting. We understand that any regulated entity should expect a reasonable period of notice to prepare to comply with new requirements. However in this case the information sought should already be to hand (planned EOIs and anticipated volumes of uncontracted gas) and, as we read it, s34 of the Regulations does not prevent a regulated supplier who makes a disclosure from subsequently planning additional EOIs or making further volumes of gas available, or require updates before the next reporting date. It should therefore be little imposition to require an initial report early in the 2023-24 financial year, potentially the end of July 2023, with subsequent updates at the currently proposed 1 January / 1 July pace.

Penalties

- Do you agree with the maximum penalties in the Code, including the allocation of provisions among the three penalty tiers?
 - Yes.
- Do you have any other comments on enforcement regimes?
 - No.

Review Mechanism

- Do you agree a review mechanism is required and the proposed frequency is appropriate?
 - A review process is definitely needed, for three reasons:
 - Current circumstances require the speedy finalisation of the initial Code design with a relatively short opportunity for analysis, feedback and iteration. In particular, the effects of the price cap and exemption arrangements are open to interpretation. Adjusting arrangements in light of experience makes sense.
 - The international energy crisis to which the Code is a response will continue to evolve and may be fully resolved over the next couple of years if current trends continue - or worsen if there are further unexpected

geopolitical shocks. It will be important to keep the Code relevant to international circumstances.

- The long-term structure of the gas market beyond the current circumstances needs full consideration. Should extraordinary price caps continue; be replaced by other measures; or revert to the status quo ante? Should price formation in the Eastern Australian Domestic Gas Market be directly linked to export markets, or structurally separated? These matters are best considered outside the urgency of our current context.
- The proposed initial review, by mid 2025 with the potential for an earlier review if the Ministers deem it necessary, is appropriately timed. There is good reason to think that international gas markets may calm over this period, and two years of Code operation will be informative.
- We suggest that the Regulations also put more definition around the timing of subsequent reviews, as it will be important to ensure that ongoing aspects of the Code remain functional. One option would be to require each subsequent review to be initiated no more than five years after the initiation of the previous review. The flexibility to commence a review sooner if warranted should be maintained.
- What conditions would warrant a review being triggered?
 - Key considerations (whether these are reflected in the Regulations or simply in policy) include:
 - Whether international energy markets, especially for LNG, have recovered from the Ukraine shock and returned to sustained balance;
 - Whether average wholesale gas price outcomes in Eastern Australia are above the cap;
 - Whether there has been a substantial change in the supply or demand outlook that either implies change in Code settings (for instance, if a demand decline implies lower marginal costs of supply or lower supply commitments needed), or that the Code is not achieving its objectives (for instance, if domestic supply commitments remain insufficient to meet expected inelastic demand).
- Do you have any other comments?
 - No.

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,

Innes Willox
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