Future of gas market regulation

Speakers:
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ACCC Chair Rod Sims delivers an address to the 7th Australian Domestic Gas Outlook Conference in Sydney. Mr Sims discusses the state of the east coast gas market and the future of regulation in this sector.

Transcript:
Check against delivery

It is a pleasure to be here today at the annual Australian Domestic Gas Outlook conference.

At this event, several years ago, there was a lively discussion about the role of natural gas in the Australian economy.

To the surprise of many Australians, I suspect, natural gas supports a vast number of Australian businesses in mining, manufacturing, chemicals and agriculture, just to name a few.

It was also touted by many as a relatively inexpensive and reliable transition fuel for electricity generation as Australia moves from fossil fuels to renewables.

Current wholesale gas prices, which in a relatively short period have become two to three times higher than historical prices, cast doubt on the extent to which natural gas can continue to fulfil these roles into the future.

Many Australian manufacturers are under extreme pressure to remain internationally competitive. The high cost of gas, and the high cost of electricity, is making it extremely hard for these businesses and poses an imminent threat.

The responsibility for addressing this inevitably falls on both governments and market participants.

Some governments are already taking steps. The Australian Government introduced the ADGSM and reached the Heads of Agreement with the LNG producers. Some state governments are releasing tenements to be developed exclusively for the domestic market.

However, gas suppliers are best placed and would be well advised to consider what they can do to provide immediate price relief to the manufacturing sector. This is a theme I will keep referring to today.

Today I will cover three topics:

1. Current wholesale gas prices and what they mean for the manufacturing sector in the east coast of Australia. While this says nothing new, it is worth repeating.
2. The need for more investment in gas development and infrastructure to lower gas prices in the medium to long-term.
3. What the ACCC will be doing for the remainder of our gas inquiry to help bring about a more transparent and effectively functioning gas market.

1. Gas prices have stabilised, but are still high for C&I gas users

In the current market dynamics, export parity prices are a key factor influencing domestic gas prices in the east coast gas market. The ACCC estimates an export parity price by calculating an LNG netback price and then uses this estimate to assess the reasonableness of domestic gas commodity prices offered and agreed in the east coast.

The LNG netback price is an indicator of the maximum price that the gas user should expect to pay for gas in a well-functioning gas market.

When the current ACCC gas inquiry commenced in April 2017, many domestic gas buyers in the east coast were receiving offers for gas supply at prices that were well in excess of LNG netback prices. The highest priced offers were made by retailers, peaking as high as $22/GJ in March 2017.

This was a clear sign that the east coast gas market was dysfunctional.

In October 2017, once the ACCC highlighted this, the Australian Government reached a Heads of Agreement with the LNG producers. Under the terms of this agreement, the LNG producers committed to offer sufficient gas on competitive terms to the domestic market.

The gas industry, of course, complained about this government intervention, but they brought it on themselves.

By the year's end, gas commodity prices in domestic offers reduced substantially and stabilised around the $8-11/GJ range. In early part of 2018, domestic prices converged with LNG netback prices and started to track them.

As LNG prices rose over the course of 2018 due to an increase in global demand for gas, so did domestic prices. By August 2018, most offers to large commercial and industrial (C&I) gas users were at, or above, the mid-$10/GJ level, including some offers above $12/GJ.

Particular groups of gas users are hit the hardest by this. These include users who:

- use gas intensively, and are therefore incurring significant increases in their input costs
- are substantially trade-exposed, or face other market imperfections, which limit their ability to pass on increased input costs, and
- have technologies, such as feedstock production, dedicated to gas and are unable to switch to other energy sources.

C&I gas users have been telling us for some time that at current wholesale gas prices, their operations are not sustainable in the medium to longer term. They are increasingly likely to relocate from the east coast or wind-up their operations.

In January, RemaPak, a producer of polystyrene coffee cups in Sydney, went into administration.

RemaPak's energy costs increased by 400% in a space of just three years. As it was competing against importers, it was forced to absorb the cost increases and this severely undermined its viability.

RemaPak considered how its production plant could be reconfigured to use an alternative raw material, such as biomass, but this did not turn up a viable solution. It then sought to diversify its sources of gas by actively participating in the domestic short term markets. In the end, however, all of this was to no avail.

RemaPak is not the first to exit the east coast; Coogee Chemicals closed down its Laverton plant in 2016.

Many other manufacturers are close to making critical decisions on their future operations. If wholesale gas prices do not soften from their current levels, it is just a matter of time before they follow RemaPak and Coogee. Once large manufacturers relocate or shut down their plants, they will not come back.

The recent rapid escalation in the cost of energy has made the east coast of Australia an increasingly unattractive proposition for investment.

The main reason we are yet to see businesses on the east coast relocate or close is likely because they are continuing to operate while their capital costs are sunk. For many of these businesses, the crunch time will come when material capital re-investment in maintenance, replacement or upgrade of their plants is required.

These key investment decisions are coming and for some they are just around the corner. At least some of these businesses will not make these investments in the absence of sufficient certainty that they will be able to acquire gas at sustainable prices in the medium to longer term.

In October 2018, at the request of gas users, the ACCC commenced publishing LNG netback prices on its website to assist users to identify trends in LNG netback prices and to estimate an indicative reference price of gas for supply over the near term.

Concerns have been raised by some market participants that the publication of the LNG netback prices is akin to the ACCC effectively setting a market price for gas. This is not the case. The ACCC is making this information publicly available to improve gas price transparency and give gas buyers the same information that gas sellers already have.

Data published by the ACCC shows that, after reaching a peak of around $12.50/GJ in September 2018, the 2019 average of expected LNG netback prices at Wallumbilla fell to about $8.55/GJ by the end of February 2019. The average of expected LNG netback prices for 2020 is about $9.20/GJ.

There are two points that I want to emphasise in relation to this.

First, these latest LNG netback price estimates are materially below the prices that were offered to domestic gas users in August 2018. We will be closely watching to see whether offers made by gas suppliers continue to track LNG netback prices on the way down, as they did on the way up.

Second, the data shows that LNG netback prices are volatile and can fluctuate quite dramatically in the short term.

I mentioned earlier my advice to suppliers is to consider what they can do to avoid excessive closures in the manufacturing sector.

The trick is to find the right balance between taking advantage of these upswings in LNG netback prices in the short term and taking a longer term view of the market. If gas suppliers do not want to drive domestic gas buyers out of the market, then do not offer prices that see businesses close.

Suppliers should also be mindful how they engage with prospective customers. Refusing to respond to requests for offers, and instead insisting that users participate in the supplier's own expression of interest processes, does not create an impression that a gas supplier is actively participating in the domestic market.

2. More investment is required to lower gas prices in the medium to long term

What the market needs to bring gas prices down in the longer term is well known. Gas producers need to accelerate investment in gas exploration and development. Pipeline operators and storage facility operators need to continue to construct and expand key infrastructure. Governments need to allow access to gas resources and encourage development of infrastructure.

These actions should materially improve the future supply outlook of the east coast gas market and pave the way to more sustainable gas prices. To avert the current crisis, these actions were required a number of years ago.

What is puzzling is why we are not seeing more investment in new gas supplies now.

There is sufficient gas in the east coast that can be economically developed. As we reported in December, there are over 11,000 petajoules of proved and probable reserves in the Surat and Bowen basins alone that are currently uncontracted.

Further, based on estimates developed by Core Energy, around 99 per cent of all proved and probable reserves in the east coast have a lifecycle cost of less than $7/GJ.

This means that current domestic gas prices should provide strong signals for more investment in gas exploration and development. However, as we reported in December, planned investment has been disappointingly slow to respond.

On the infrastructure side, most market participants are not currently prepared to enter into long-term agreements to underwrite pipeline expansion on key transmission pipelines. In addition, despite the growing importance of storage in the market, there has been limited investment into additional storage capacity in the east coast.

There are a number of factors at play. Changing market fundamentals and structure are affecting expectations about future gas availability and prices. Measures introduced to address market failures, such as the transportation capacity trading reforms and other transparency measures, have not yet come into full effect. Other policy measures, such as moratoria and regulatory restrictions, are impeding gas exploration and development.

However, a key feature of this market is that the decisions about the timing of development of reserves and resources are largely concentrated in the hands of a handful of major gas producers. Over 80 per cent of proved and probable reserves and close to 65 per cent of contingent resources are controlled by the LNG producers in Queensland.

The timing of the development of uncontracted reserves is critical for the domestic market. The ACCC will be closely monitoring decisions made by gas producers to develop these reserves.

Governments also have an important role to play to ensure that gas is brought to market sooner rather than later.

We welcome the announcement last week that the Queensland government has approved the development of Arrow Energy's Surat Gas Project.

However, in December, we reported on substantial write-downs of CSG reserves in Queensland over the past 12 months by the key suppliers. Arrow Energy in particular has re-classified nearly 3,000 petajoules of its proved and probable reserves into contingent resources, predominantly in the Bowen Basin.

This move will now mean that there will be a delay in bringing this significant quantity of gas to market and will also likely result in a delay in constructing the critical pipeline infrastructure that would enable other suppliers in this area to bring gas to market.

This raises a crucial point. In such a tight market, governments need to actively monitor compliance with licence requirements and implement any measures necessary to ensure that large gas producers do not withhold (or warehouse) gas from development and production to suit their commercial priorities.

Further, where new smaller players like Blue Energy in the Bowen Basin are willing to take on the risk of new pipeline or gas developments, governments should be looking to do what they can do to facilitate a vibrant competitive gas market that will benefit the whole of the Australian economy.

We continue to urge state governments to adopt policies that consider and manage the risks of individual gas development projects, rather than implementing blanket moratoria and regulatory restrictions.

This is particularly critical for gas users in the southern states, who are likely to become increasingly reliant on gas from interstate or overseas, due to substantially smaller quantities of uncontracted reserves in the south and little prospect of new developments in the near term.

More supply and greater diversity of suppliers are needed in the south to bring domestic gas prices down. The most substantial pricing benefits for domestic gas users will be achieved if additional lower-cost gas is produced in the south, rather than transported from Queensland, the Northern Territory or imported via an LNG import terminal.

3. ACCC to continue to promote transparency, monitor progress of reforms and monitor the operation of the market

I now turn to the role the ACCC has been playing, and continues to play, in the market.

Over the course of the current inquiry, we have undertaken substantial work to promote transparency, monitor the progress of reforms, and report on the operation of the gas market.

More transparency is needed to assist market participants

As many of you know, the gas market in eastern Australia has traditionally operated in a very opaque manner. This opaqueness has hindered the ability of the market to respond efficiently to the changing market conditions.

We have therefore sought, in this inquiry, to improve transparency by publishing a range of information on upstream activities, transportation and storage services, and the prices paid for gas and infrastructure services.

The publication of this information, combined with other recently implemented transparency measures and reforms, has reduced the degree of information asymmetry that gas users can face when negotiating with suppliers, pipeline operators and storage providers.

But there is much more work to do.

We recently provided to the Australian Government and the COAG Energy Council a joint report prepared with the Gas Market Reform Group on measures to improve the transparency in the gas market.

The joint report raised a number of issues.

First, it emphasised that the level of transparency in the east coast gas market is poor compared to other developed countries. Market participants in the east coast have less access to information on key supply and demand fundamentals than their counterparts in New Zealand, the United States and the European Union.

While steps have been taken to improve transparency, there are still some significant information deficiencies. Not enough information is available about:

- reserves and resources and other upstream activities;
- infrastructure availability and developments;
- gas and infrastructure prices; and
- LNG shipments and operations.

This lack of transparency limits competition. Limited competition in the supply, retail and infrastructure segments of the supply chain puts additional pressure on the east coast gas market.

To address this, the joint report recommended the implementation of a range of transparency measures, spanning all aspects of the supply chain.

One such transparency measure is the reporting framework for reserves and resources. The current reporting of reserves and resources across the east coast is fragmented and inconsistent. To address this, the joint report recommended that suppliers should be required to report information on their reserves and resources to AEMO on a consistent basis, based on the reporting framework developed by the ACCC.

On 19 February 2019, the ACCC released a consultation paper on the proposed reporting framework. The ACCC is seeking submissions from interested parties by 12 March 2019. The ACCC intends to complete its work on the reporting framework by April 2019, so that it can form part of the broader consideration of the transparency measures by the COAG Energy Council.

A more efficient transportation network is required to enable gas to more easily move to highest value users

In a tight market, access to competitively priced capacity on key pipelines has become critical to ensure that gas can freely move to where it is needed the most. Another key area of focus for the ACCC is therefore the progress of the pipeline reforms, many of which have been implemented in response to the findings from our last inquiry.

These reforms are two-fold. First, a new information disclosure and arbitration framework was implemented on 1 August 2017. It is intended to place a constraint on the exercise of market power by pipeline operators that were previously unregulated.

Second, a range of capacity trading reforms came into effect on 1 March 2019. These reforms should improve the efficiency with which capacity is allocated and used by increasing incentives for shippers to trade capacity and by posing constraint on the prices charged by pipeline operators for secondary capacity.

While it is too early to assess the impact of these reforms, evidence is beginning to emerge that they are putting downward pressure on the prices for pipeline services and that pipeline operators are becoming more responsive to their customers' needs.

While this is a positive sign, the ACCC has some concerns with the information that has recently been published by pipeline operators that are subject to the new information disclosure requirements.

Further refinement of the information disclosure requirements, and greater scrutiny of the information published by pipeline operators pursuant to those requirements, may therefore be necessary. The ACCC is currently collecting relevant information from pipeline operators and will report on its examination of this material in July 2019.

More generally, the ACCC will continue to monitor the effectiveness of the transportation reforms and advise the Australian Government and the COAG Energy Council on how the reforms are working in practice and what further changes, if any, may be required.

The ACCC to review the costs and margins of the three largest retailers

As we reported in December, the ACCC is currently reviewing the costs and margins of the three largest gas retailers – AGL, EnergyAustralia and Origin.

Preliminary analysis shows that the average earnings before interest, tax, depreciation and amortisation of the three retailers over the period from 2014 to 2017 ranged from $1.60/GJ to $2.29/GJ and accounted for 15 to 21 per cent of the delivered price of gas.

It is too early for us to comment on the significance of these results as the findings are highly aggregated. We expect to be reporting in more detail on this in July.

Future work of the inquiry

The ACCC gas inquiry is due to finish in April 2020.

For the remainder of the inquiry, the ACCC will continue to focus on the issues I raised today and to monitor the actions of market participants across the entire supply chain.

The ACCC will also continue to improve transparency in the east coast gas market by publishing key market information, monitoring the effectiveness of reforms and monitoring the operation of the market.

Conclusion

I began today by advising suppliers to consider what they can do to provide immediate price relief to C&I gas users.

We must all remember that, when the liquefied natural gas (LNG) projects in Queensland were being commissioned, they promised that this current crisis would not happen.

I remember suppliers assuring the Queensland government that investment in gas exploration and development would be timely; that a reservation policy in the east coast was not required; that businesses would be protected and their futures secured.

And yet today we are dealing with these very issues.

If more businesses start to fail, pressure will inevitably ramp up again on governments to do more; indeed, a lot more.

I therefore conclude on a vital point. The east coast of Australia is just about the only region in the world that has both gas exports and a liberalised gas market. It should be a privilege for gas producers to operate in a country that embraces a free market: that privilege should not be taken for granted.

Thank you for your time today.