Reforming the East Coast gas market

Solutions to keep gas-intensive manufacturing in Australia

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1. The case for urgent market reform

Australia's East Coast gas market is undergoing a profound structural change, caused primarily by the rapid development of a liquefied natural gas (LNG) export industry, which will see a trebling in demand for gas from the east coast of Australia as it links to markets in Asia.

While there are significant benefits to Australia of a major new Liquefied Natural Gas export industry on the east coast, the impact on domestic downstream gas users – both industrial and residential – is substantial.

Recent modelling by Deloitte Access Economics[1] shows that supply constraints, market dysfunction and higher gas prices will have impacts across the economy including mining, agriculture, electricity and water, construction and trade, transport and commercial & services.

The industrial impact is especially felt in the manufacturing sector. Natural gas is essential to a range of manufacturing industries, both as a feedstock in manufacturing plastics and chemicals (Australia's second-largest manufacturing sector) and fertilisers and explosives (which support Australia's two primary export industries agriculture and resources); and as a favoured energy input in other manufacturing, especially alumina, bricks, cement, float glass, steel, glass container manufacturing, paper and roof tile production.[2]

With its significant gas usage and high trade exposure, the manufacturing sector is projected to decline by up to $120 billion by 2021[3] unless this issue is addressed urgently, with projections also suggesting between 13,000[4] – 83,000[5] direct manufacturing jobs are at risk. The situation is already contributing to plant closures and redirected investments from existing manufacturing business, and also lost opportunities for new investment.

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1 Deloitte Access Economics, *Gas market transformations – Economic consequences for the manufacturing sector* (July 2014)
2 Manufacturing Australia (MA), *Impact of gas shortage on Australian manufacturing* (May 2013) p.3
3 Deloitte Access Economics *Gas market transformations – Economic consequences for the manufacturing sector* (July 2014) p.3
4 Full time equivalent jobs lost to 2021, ibid p.3
5 Manufacturing Australia (MA), *Impact of gas shortage on Australian manufacturing* (May 2013) p.3

The household impact is just as significant. Gas price rises will hit domestic gas users hard – particularly those on fixed incomes. Household gas prices are already rising, and are expected to increase by around 17.5% in 2015/2016[6].

A transitional crisis has emerged. Best-case scenarios see the benefits of new gas supply, market reforms and other measures flowing through to households and industry late this decade. This will be too late; in some cases it is already too late. If gas intensive manufacturing leaves Australia it is not likely to return – even if prices revert to sustainable levels – because of high costs of project construction, loss of skills and supporting supply chains, and higher risk premiums.

Manufacturing Australia believes that we can have both a successful export LNG industry and a successful manufacturing base, but to do so we must urgently tackle the substantial and growing uncertainty and insecurity in domestic gas supply, and address the lack of a competitive and transparent domestic gas industry.

[6] IPART (2014) *Fact Sheet: Regulated retail gas prices rises from 1 July 2104 to 30 June 2016*, p.1

2. Recognising market failure

The Federal Government's Energy White Paper recognises that there are problems with the competitiveness and transparency of the gas market on the east coast of Australia and reform is needed.

The Federal Government has indicated that it is reluctant to intervene in the market. However, interventions by state governments to impose regulatory bans on potential new gas supplies, as well as large gas producers being allowed to rapidly consolidate the market, to 'sit-on' reserves, sell tranches of gas to each other, withhold supply from the domestic market and jointly market their gas have combined to create a highly dysfunctional and imbalanced market. The market in its current form is unlikely to correct itself without intervention, and certainly not in time to prevent further weakening of Australia's competitive position for manufacturing investment.

The Australian market for gas has profoundly changed with the development of export LNG. Export markets could easily consume Australia's entire gas production. In the future, the domestic market will account for a small portion of domestic production. LNG development has introduced many export customers for Australian gas, but the number of suppliers to the domestic market remains very small. These changes have rendered the domestic market, dominated by historical structures and regulations, unworkable for demand side participants.

A handful of economic interests control almost three quarters of current reserves, while a similarly small group control almost 90% of Australian gas production[7]. At the present time, only a small fraction of available reserves is available to the Australian domestic market, and despite the opening of export markets, joint marketing to the domestic market is still permitted.

Confidence amongst industrial energy users in market outcomes and supply security is very low. In this context, the contention that the essential solution is simply more gas supply is insufficient. More supply is important, but more supply into a gas market that is not functioning effectively will not address the current inequities.

[7] Research commissioned by CSR Limited

What is more important to a functioning market is to have more *suppliers.* Transparency and opening of the domestic market to competitive functioning is imperative to restoring confidence in the market to deliver.

Manufacturing Australia supports the Federal Government's vision, as outlined in the Energy White Paper, of a gas market with diverse suppliers, additional supply, appropriate infrastructure and competitive, transparent, trading markets.

But there is a lot of work to be done to achieve that vision, and as the Energy White Paper acknowledges, the current reality of the Australian gas market is very different to the ideal.

The objective of market reforms should be to create a market structure that benefits exports, domestic industry and households, namely:

- An abundance of gas for export and domestic supply;
- A larger number of gas producers competing in the market;
- Access to infrastructure to enable producers to bring their product to market; and,
- Daily publication of accurate and credible gas supply availability and price.

3. How to fix the East Coast gas market

Fixing the east coast gas crisis will require the efforts of Federal and State/Territory governments, along with industry. If the following four key goals can be achieved, then the domestic manufacturing industry's confidence in the gas market will likely return in the medium-long term.

1. Restore competitiveness to the domestic gas market
2. Improve gas supply security
3. Develop gas infrastructure for Australia's future
4. Encourage new gas producers to enter the market

Manufacturing Australia does not advocate retrospective reservation of gas supply. If the following Action Plan can be implemented within the next 12-18 months, we believe gas reservation can, and should, be avoided. However, if this action plan cannot be implemented urgently, governments (both State and Federal) are likely to face mounting calls for emergency gas reservation to prevent widespread offshoring of gas-intensive manufacturing.

Action Plan

Goal	Actions
Restore competition to the domestic gas market	1. AEMO should develop additional gas trading hubs, such as that which has been proposed at Moomba. All gas should be delivered, priced and traded at designated hubs and published against a benchmark price. As further pipelines and supplies are developed, other hubs can be added to the marketplace. 2. The ACCC should revoke approval of joint gas marketing arrangements to encourage competition between gas producers. 3. AEMO should require gas producers to report and regularly update the market on proven and probable gas reserves. Currently, this information is not in the public domain and claims by gas producers cannot be validated. 4. Similarly, AEMO should require pipeline transport pricing to be published based off a published benchmark price for the injection and withdrawal points; open access via electronic markets provided to all market participants; participants requiring shipping can price and book transport off the electronic market.
Improve gas supply security	5. State governments should encourage onshore gas development by: • adopting a transparent, three-tiered, approach to sharing gas royalties with landholders, immediate neighbours and the local community; • providing additional incentives, such as differential royalties treatment, where gas remains in Australia; and, • developing a National Regulatory Framework to streamline and standardise regulations relating to gas exploration and production.

	6. Federal and State/Territory Governments should stop the supply constraints and market manipulation caused by gas producers hoarding or withholding gas from the domestic market. This could be achieved through either a "use it or lose it" policy (whereby producers lose their gas reserves if economically viable projects are not brought to market in a reasonable timeframe), or by charging a fee for sitting on undeveloped acreage – effectively a storage cost. 7. AEMO should ensure the gas market is balanced on a daily basis and actively manage LNG exports so that exports are curtailed on days where shortfalls are experienced in the domestic market. According to AEMO's own estimates, this would impact exports of LNG by < 0.1% on an annual basis.
Develop robust gas infrastructure for Australia's future	8. The Federal Government should designate gas pipelines as assets of national importance as a key step to ensure equality of access. 9. The COAG should map and develop a network of pipelines to bring Australia's stranded gas assets to market and connect the Northern Territory and Eastern gas markets. 10. Federal and State governments should identify strategic "energy corridors": regions or zones that are crucial to future energy needs, either for resource extraction, pipelines or other infrastructure.
Encourage new gas producers to enter the market	11. Federal Government initiatives should encourage direct investment in upstream gas development from local and overseas investors. The recent collapse in the oil price has created a consequential collapse in investment in gas exploration & development by current and emerging producers. Federal Government support for tax effective investment structures would promote private investment in gas development and ensure a return to Government in the form of taxation on commercial activity which otherwise would not have occurred. For example, in the US, Mutual Limited Partnerships invest in energy infrastructure. There are more than 100 MLPs trading on US various stock exchanges. 12. The AER should extend the National Gas Access Arrangements to gas production facilities where they have monopoly positions so that all gas producers can have access on an equal footing. 13. Governments should restrict the capacity of any one entity, joint venture, or partnership to control a large or dominating share of reserves, while promoting entry of new competitors from the point of resource control and extraction.

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