

23 February 2023

Submitted email adgsm@industry.gov.au



Dear Sir/ Madam,

Australian Domestic Gas Security Mechanism Guidelines

The Australian Financial Markets Association (AFMA) is responding to the consultation on the draft Australian Domestic Gas Security Mechanism (ADGSM) Guidelines.

AFMA is the leading industry association promoting efficiency, integrity, and professionalism in Australia's financial markets, including the capital, credit, derivatives, foreign exchange, energy, carbon, and other specialist markets. Our role is to provide a forum for industry leadership and to advance the interests of the markets and their respective participants. Our membership is comprised of over 125 of Australia's leading financial market participants, including Australian and foreign banks, securities companies, state government treasury corporations, fund managers, energy firms, as well as other specialised markets and industry service providers.

AFMA represents many of the key participants in the east coast gas market. AFMA advocates for the role of markets in managing supply and demand, including in the energy sector. Since the recent volatility in global gas prices, we have observed that the Government has looked to introduce a range of measures, including: a revised Heads of Agreement, a gas price cap, the proposed mandatory code of conduct, the reasonable pricing principle, extending AEMO's powers and functions to manage east coast gas adequacy and the proposed reforms to the ADGSM while also investigating options for a gas reliability standard for the east coast gas market. While AFMA appreciates the policy makers desire to ensure adequate gas supply at acceptable prices we are concerned that in combination these reforms could distort commercial decision making in the east coast gas market resulting in inefficient use of gas and inadequate supply, to the long term detriment of Australian consumers. Our recent submission to Treasury's consultation on the *Competition and Consumer Amendment (Gas Market) Bill 2022* raised concerns about the long-term impact on the gas market of price regulation under the proposed mandatory code of conduct.¹ Similarly, we are responding to this consultation as we are concerned that the proposed Guidelines will obscure market signals in the domestic gas market and therefore limit the ability of the market to match supply and demand. We are concerned that, like Treasury's Bill and other related reforms, rather than securing domestic supply, the proposed Guidelines may undermine the ability of the market to satisfy domestic demand and will result in an

¹ <https://afma.com.au/getattachment/7cf91a6d-d243-4084-b242-e67fb83c192c/R081-22-CCA-Gas-Market-Bill.pdf?lang=en-AU&ext=.pdf>

ongoing need for government intervention to ensure customers are able to access gas and while we are responding to the consultation on the ADGSM we think policy makers need to consider this policy in the context of the totality of gas market reforms and recommend that their combined impact on the market should be reviewed.

1. Role of market signals

Markets are effective mechanisms to efficiently match supply and demand by providing price signals for efficient investment and use of resources. Historically, markets have functioned well to incentivise investment in new gas production to ensure adequate supply. In markets with high upfront costs, such as gas, price signals provide incentives for users of gas to enter into long term contracts to underwrite the development of new projects in exchange for favourably priced gas. Interfering with these signals either directly, as contemplated by the ACCC's proposed mandatory code of conduct, or indirectly, by administratively directing additional supply into the market; risks undermining the incentives for long term contracting that underwrite investment decisions of both domestic and export focused producers and their ability to raise capital for production investment.

Short term price signals are important for incentivising rational behaviour such as the storage of gas in Iona to meet winter demand. AFMA is concerned that if, for instance, participants are aware that the Government is likely to declare a shortfall through winter they may face a perverse incentive not to store gas on the belief that that they will be able to acquire it more cheaply in the future from LNG producers who will be forced to sell into the spot market.

We are also concerned that the proposed approach of compartmentalising the market into calendar quarters may not be appropriate for the east coast market. Domestic demand is primarily driven by weather which does not necessarily align well with calendar quarters. For instance, a late start to winter in Victoria can lead to lower demand in April and higher demand in May and June. If Q2 was determined to be a shortfall quarter, in a year with a late starting winter, market demand may not be sufficient in April to warrant excess volumes supplied by LNG participants. This is likely to result in an oversupply of gas in April which could lead to LNG producers curtailing output as there is inadequate demand for it domestically, storage capacity is likely to be full in anticipation of winter and the ADGSM prevents them from exporting it. We consider that this is a poor result as the LNG producer may be prevented from meeting their contractual demand even though there is inadequate domestic demand for their gas.

While AFMA appreciates that the Government wants to be confident it has appropriate emergency powers to mitigate gas shortages we are concerned that the proposed Guidelines will undermine long term price signals by introducing the prospect of regular short term government intervention which will disincentive long term contracting leading to reduced investment and ultimately less supply.

2. Dangers of a short-term focus

The most fundamental change in the revised Guidelines is to move the minister's determination of a domestic gas shortfall from annual to quarterly. AFMA understands this change was motivated by an understanding that demand for gas is seasonal and that while there may be adequate supply averaged across the whole year, the ADGSM should be able to deal with seasonal shortages. While we appreciate the logic of this approach, we think the mechanism to implement it will cause significant uncertainty in the market as having four decision points when the minister can intervene during a year will limit participants ability to plan ahead.

Traditionally, most supply in the domestic gas market is managed under annual or multi-year contracts. These contracts allow gas users to manage their dual risks of supply shortage and unacceptable spot price outcomes, while giving producers confidence to invest in long term assets based on their contracts to supply gas. The price agreed under these contracts reflects the underlying dynamics of supply and demand in the market with producers incentivised to increase supply and users incentivised to use gas more efficiently when prices are higher. These contracts also give lenders and investors confidence to fund producers' investment in expanding capacity to ensure that there is adequate supply.

The prospect of government intervention in the gas market during the term of a contract undermines the incentives to strike these agreements. Gas users faced with higher prices due to tight domestic supply may logically decide not to contract on the basis that the government will intervene and direct additional gas into the market that they will be able to acquire at lower prices. Conversely, producers, including those focused exclusively on the domestic market, who are unable to sell gas domestically, may either direct it to export customers or not extract it in the first place. The direct result of this collective decision-making is that domestic supply shortages are more likely, therefore indirectly causing the minister to need to trigger the ADGSM. While not AFMA's preferred approach, the current arrangements provide significantly more certainty as the minister will generally notify the market of their intention to make a decision six months prior to the start of the year and make the decision three months prior to the start of the year. This approach gives producers and users greater certainty to contract for the full year, than under the proposed Guidelines where decisions will be made 1.5 months before the start of a quarter.

AFMA's view is that the ADGSM will work more effectively if it is designed to give good long-term signals that give the market and AEMO an opportunity to address supply shortfalls without a need for ministerial intervention. While we acknowledge the Government's desire to have the flexibility to address seasonal supply issues, we think it would be preferable to have a decision-making framework that provides longer term signals. We think this could include:

- Requiring the bodies providing advice about forecasts to the minister to provide longer term multi-year forecasts, in a way similar to AEMO's current Gas Statement of Opportunities. The forecasts should be published to allow the market to respond to them and potentially mitigate foreseen issues.
- The framework for making decisions annually should be retained to give the market greater certainty, but it could be enhanced to allow decisions to address shorter term supply issues that occur for only part of the year. If considered necessary, the minister could also retain powers to amend the decision during the year if circumstances require.

Recommendations

- i. The minister should receive longer term advice about shortfalls.
- ii. This advice should be published to allow the market to respond.
- iii. Shortfall decisions should continue to be made for a full year but should be able to address shortfalls that occur for only part of the year.
- iv. If considered necessary, the minister could be given the power to amend decisions during the year where necessary.

3. Lack of clarity about what is a shortfall

The framework proposed in the Guidelines for determining if there is a domestic shortfall is highly discretionary. AFMA is concerned this could undermine market confidence and limit the willingness of participants to contract as they will be uncertain under what circumstances the minister will choose to intervene. While we can understand that there may be circumstances where discretion is required, we think the market would benefit from clarity about what amounts to a shortfall.

AFMA thinks the Guideline should be clear that unwillingness of users to contract at the market price and their subsequent inability to access gas, should not constitute a shortfall requiring ministerial intervention. We suggest that a shortfall should be defined as a situation where, but for the ministerial intervention, the gas system will be physically unable to supply mass market demand, contracted C&I demand and anticipated generation demand.

Recommendations

- v. The Guidelines should contain greater clarity about what constitutes a shortfall.

4. Investment in the southern states

A recent feature of the east coast gas market is that the majority of domestic demand is located in the southern states, while the vast bulk of new production has located in Queensland. With the decline of existing fields in the southern states one of the key challenges for the market has been ensuring adequate supply to meet southern demand. The market anticipates that this issue will ultimately be solved through a combination of; new field developments in southern states, LNG imports and increased north-south gas flows.

We are concerned that the ADGSM could hamper market efforts to address southern state supply as the prospect of large volumes of gas being redirected to the southern market at short notice could undermine the business case for the investments required in the southern states. Additionally, we are concerned that constraints within the transmission system mean that additional supply from Queensland under the ADGSM may not be able to address southern state shortfalls caused by a failure to invest in additional capacity in the southern states.

Recommendations

- vi. Market signals should be allowed to operate to drive efficient investment in new capacity in the southern states.
- vii. Governments should remove regulatory obstacles to this investment in the southern states.

5. Protections for existing contracts

The rationale for the ADGSM is that demand from the east coast's large LNG export industry could result in domestic gas shortages; and therefore, the government needs to be able to redirect a portion of this supply to the domestic market to avoid potential shortfalls. For the ADGSM to work, on its own terms, it is necessary for the east coast to have a large and thriving LNG industry with substantial reserves that can be supplied to the domestic market. The Guidelines approach to LNG export contracts could undermine this approach.

The Guidelines provide very limited protections to existing LNG supply contracts and no protection at all to new export contracts that LNG producers may enter into. This is likely to reduce their incentives to invest in new production and undermines their attractiveness to financiers and foreign buyers. These factors could lead to reduced investment in gas production for LNG export, which ultimately will result in less gas that is able to be diverted into the domestic market. The ADGSM should therefore be designed in a way that protects the viability of LNG exporters to ensure that they continue to invest in new gas production, so that there are adequate reserves to supply the domestic market.

Recommendation

- viii. The Guidelines should preserve contractual rights for both existing and new LNG export contracts.

6. Exit strategy

During 2022, Australia and the world experienced extremely unusual volatility in energy prices caused by a range of factors including seismic geo-political events. Markets have responded strongly to this volatility by allocating gas to the highest value uses and developing new supply in response to high prices. As a result, of the market response and a mild northern hemisphere winter, international LNG prices are now at lower levels than they have been since the escalation of the conflict in Ukraine in early 2022. It should be noted that the market response, in conjunction with government policy, has led to the recent reduction in east coast forward prices as they converge with global prices, this can particularly be seen in the pricing of marginal gas in winter, which is now close to LNG netback for winter 2023 and 2024.

AFMA is concerned that the Government, with the ADGSM and the related reforms, is introducing permanent regulatory changes to address short term volatility that has largely already been corrected by the market. These changes are likely to have a negative impact on the market, resulting in reduced contracting and investment; which in the long term, may lead to the supply shortages the policies are intended to avoid and may require government to intervene more frequently to avert them. AFMA's view is that in the long term, there is no alternative to letting market prices determine supply and demand. As a result, we consider that any intervention intended to mitigate the impact of undesirable short term volatility should be limited and have a clear path to allow the market to return to normal operation; as otherwise governments are likely to find themselves in an ongoing, and ultimately fruitless, struggle to allocate resources without a price signal. We therefore recommend that the ADGSM should be designed as a last resort power to mitigate actual physical shortages in extreme circumstances, when other tools such as AEMO's supply adequacy powers are inadequate, rather than as a regular feature of the gas market regulatory architecture. We recommend that the ADGSM and the related reforms should be formally reviewed after 12 months of operation to examine if they are achieving the Government's objectives.

Recommendations

- ix. The ADGSM should be designed to allow markets to work in all but the most extreme circumstances.
- x. The ADGSM and the related gas market reforms should be reviewed after 12 months of operation.

AFMA would welcome the opportunity to discuss the development of the ADGSM as is keen to assist in the development of policy that will work with the gas market to achieve the Government's objectives of secure and affordable gas. Please contact me on 02 9776 7994 or by email at lgamble@afma.com.au.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Lindsay Gamble', written in a cursive style.

Lindsay Gamble
Policy Director