13 November 2023

Department of Industry, Science and Resources

Submitted online

Dear Sir/ Madam,

Future Gas Strategy – Consultation Paper

The Australian Financial Markets Association (AFMA) is responding to the Department of Industry, Science and Resources (DISR) Future Gas Strategy Consultation Paper.

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 many of the energy firms who participate in the Australian gas market. Our comments are focused principally on the east coast gas market.

Key Points

- **AFMA supports government developing an overarching strategy to consider the role of gas in the transition to net-zero**
- **Gas markets will contribute to the transition**
- **Lack of consistent policy about the role of gas is blunting market signals and complicating investment decisions**

AFMA welcomes DISR's initiative to develop a strategy for the future of gas. As identified in your paper gas currently plays critical roles in the Australian economy, including as; an energy source for households, a key input for resources and manufacturing businesses and as a fuel for electricity generation. Additionally, Liquified Natural Gas (LNG) exports are a major source of export earnings and tax revenues and Australia's reliability as a resource exporter is a key factor in our relationships with a number of key trading partners. The transition of the Australian economy to net-zero is already having a major impact on the gas sector and the economy as a whole and AFMA considers that a clear strategy about the future role of gas will be critical to ensure that the market is able to make efficient investment decisions to identify areas where gas usage can be reduced and to ensure that adequate gas is available for the remaining demand.

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1. The market for gas

Key Points

- **Markets support efficient investment in and use of gas**

Natural gas is an internationally traded commodity with strong international markets and a developing east coast market. These markets have functioned effectively to support efficient investment in gas production, transportation and storage infrastructure and to encourage the efficient use of gas in the east coast market. Recent disruptions to international markets and the resulting reactive domestic policy decisions have restricted the ability of the market to respond to the current short and medium term challenges, but AFMA considers that with appropriate policy certainty the gas market can play a key role achieving the Government's supply and de-carbonisation objectives.

Investment in gas infrastructure is characterised by long term projects with high upfront capital costs. In the last decade there has been significant investment in unconventional gas resources and further investment is likely to be required to ensure adequate gas supply for the east coast as older conventional fields in the south continue to decline and the market becomes more reliant on northern supply. Prior to 2022 strong markets allowed investment to occur, without the need for government support, as market participants justified their investment decisions based on the opportunity to receive market prices for their gas. Investment has typically been underwritten by long term physical contracts with gas financial markets playing an increasingly important role.

Markets have also been an effective mechanism to efficiently match supply and demand in operational timeframes by providing price signals to ensure gas is delivered to the highest value uses. The east coast gas spot markets have performed well in this role by incentivising wholesale market participants to ensure gas is available to meet operational needs by ensuring they have an adequate supply of gas and the transportation and storage services to ensure they can get it to where it has the highest value. Intermediaries, such as gas retailers, play a critical role in the market by both ensuring adequate gas is available to meet market demand and protecting end customers from spot price volatility through fixed priced supply contracts.

The recent lack of policy certainty has complicated investment decision making for the gas industry and AFMA is concerned that this inhibits the private sector's ability to respond to the market's current challenges. This gas strategy should look to improve certainty by considering the overall impact of a number of related policies on the gas sector. Areas AFMA considers should be considered include; the intersection of gas and carbon policy, the treatment of gas fired generation in the electricity market, state government restrictions on gas development and the market impact of the Commonwealth's gas market intervention.

2. Gas in the net-zero transition

Key Points

- **Gas will continue to play an important role in the transition to net-zero**
- **Appropriate market signals can identify the:**
  - **lowest cost sectors to decarbonise**
  - **appropriate mix of low carbon technologies**

Your consultation paper has rightly identified the decarbonisation of the Australian economy as a key objective for the Future Gas Strategy. Gas' role in Australia, and the regions, net-zero transition is complicated as natural gas is both a major source of Australia's carbon emissions and a contributor to the decarbonisation of the electricity market in Australian and overseas, by providing flexible firming capacity to support the deployment of variable renewable generation. Additionally, replacing natural gas as an input in a number of critical industrial processes is likely to be challenging in the short term. AFMA considers that developing clear policies about the future role of gas in; the electricity sector, as a fuel source for residential and commercial users, an input for industrial processes and an export product will be critical to allow the market to make investment decisions and to allocate gas efficiently between users.

2.1. Impact of carbon policy

Much of your paper is focused on consideration of the challenges of decarbonising different gas using sectors of the economy. While AFMA appreciates that there will be different challenges for each type of gas users we consider that with appropriate carbon and gas price signals markets will be the most efficient way to determine; where reducing gas usage is the lowest cost way to reduce emissions, which technologies are best suited to help reduce emissions and to ensure that gas is allocated to sectors where it is most needed and most difficult to replace. AFMA's view is that with appropriate price signals for gas and carbon gas users will be incentivised to reduce their emissions and determine their gas requirements. Our view is that market driven decisions are likely to be the most efficient way to reduce emissions and allocate gas to users and we consider that government policy should be focused on difficult to decarbonise sectors, such as steel making and fertilizer production which limited alternatives to gas.

While AFMA supports the market determining the most efficient way to reduce carbon emissions and the extent to which gas is part of a future fuel mix we want to share our observations of current trends in gas usage and thoughts on what these suggest about the future. Our main observation is that the residential and small business sectors seem to be embracing electrification, we note AEMO's 2023 Gas Statement of Opportunities predicts declines in small customer gas usage and the number of gas connections under all scenarios, which they attribute principally to electrification.[1] The long held consumer preference for reverse cycle air conditioning, that can provide both heating and cooling, has caused a long term decline in the use of gas for space heating for small customers. As a small customer's gas demand decreases the cost of retaining their gas connection becomes a larger part of their bill and we anticipate that an increasing number of customers will chose to disconnect gas, as indicated by AEMO's expectation of declining numbers of gas connections. This trend is likely to be exacerbated by increases in gas prices, state government policies restricting new connections and supporting electrification, the relatively higher carbon cost for gas as the electricity sector decarbonises and the low cost of electricity for customers with solar power. Our observation is that on current trends it appears that electrification is likely to be the preferred de-carbonisation choice for small customers.

Small customer's preference for electrification should be considered when considering policy regarding the role of renewable gases. While we consider that renewable gases, including green hydrogen and biomethane, could play an important role in the net-zero transition AFMA's understanding is that renewable gases are currently not priced competitively with either natural gas

[1] https://www.aemo.com.au/-/media/files/gas/national_planning_and_forecasting/gsoo/2023/2023-gas-statement-of-opportunities.pdf?la=en

or in many cases electrification, and that they are unlikely to be available in sufficient scale or at an appropriate price to substitute for natural gas usage for some time. As we pointed out in our submission to the consultation on the National Hydrogen Strategy[2] we have reservations about the efficiency of government support for projects that seek to co-mingle renewable gases with natural gas to reduce the carbon intensity of the blended gas supplied to small customers. In our view this is likely to be an expensive way to deliver carbon reductions compared to electrification and in the long term consumer preference for electrification is likely to make this approach redundant. As we said in our National Hydrogen Strategy submission we think government renewable gases policy would be more effectively focused on supporting projects to deliver renewable gases to difficult to decarbonise sectors, such as cement and fertiliser manufacturing, where there is currently no practical alternative to natural gas and users are likely to be more willing to pay a premium for low emission fuels to meet their obligations under the safeguard mechanism.

AFMA Recommendations

i. Carbon and gas prices should play a critical role in determining how sectors decarbonise.

ii. Government support for renewable gases should focus on sectors with difficult to reduce carbon emissions.

2.2. Challenges for electricity generation

AFMA considers that the role of gas-fired generation is one of the key policy challenges in the net-zero transition, which AFMA considers that government has not fully resolved. Gas-fired generation is expected to play a key role during the transition of the energy market to net-zero by providing firming capacity to support increasing quantities of variable renewable generation. Under the most likely scenario in its 2022 Integrated System Plan (ISP), AEMO anticipates that the majority of coal fired generators will retire by 2030 but anticipates a "critical need for peaking gas-fired generation … through the ISP time horizon to 2050" to provide part of the firming capacity required to support increasing volumes of variable renewable generation.[3] Our current understanding is that renewable gases are unlikely to be available in the quantity or at a price to make them competitive as a fuel source for electricity generation in the foreseeable future so natural gas is likely to remain a key fuel source in the medium term. Gas-fired generation is likely to play a particularly important role as a source of long term firming capacity to support the grid during extended periods of low renewable availability that are likely to occur occasionally as a result of unusual weather patterns, such as long periods of below average wind speeds or extended overcast periods. AFMA is concerned that government policy on the future role of gas-fired generation is uncertain as there is a tension between recognition that it is required to support the roll out of renewables and the government's desire to reduce fossil fuel use. AFMA is concerned that this lack of clarity undermines the ability of the market to invest appropriately in the assets needed to support the net-zero transition.

At a high level the challenge for the electricity sector is that the influx of low marginal cost variable renewable generation has undermined the economics of many conventional generators, this has contributed to the rapid reduction in the amount of firming capacity in the NEM as coal fired generators have become unprofitable and exited the market. This change has led to large reductions

[2] https://afma.com.au/policy/submissions/2023/r47-23-dcceew-national-hydrogen-strategy-review.pdf?ext=.pdf

[3] https://aemo.com.au/-/media/files/major-publications/isp/2022/2022-documents/2022-integrated-system-plan-isp.pdf?la=en

in carbon emissions from the electricity sector but has created operational challenges as less firming capacity is available to provide power when renewables are not available. The Government has responded to this challenge with the Capacity Investment Scheme (CIS) which is designed to support zero-emission firming capacity. As stated in our response to the Government's CIS consultation AFMA is concerned that by subsidising the entry of new capacity, without providing any support to existing gas-fired units, Government risks the new units undermining the economics of existing gas-fired capacity leading them to close sooner than currently anticipated.[4] In a worst case scenario this could result in the scheme failing to increase the quantity of firming capacity in the electricity market. To avoid this outcome, AFMA recommends developing targeted policies for gas-fired generation, that will work alongside carbon pricing, to support the net-zero transition.

AFMA Recommendations

iii. Gas and electricity policy should be coordinated to ensure gas-fired generation can continue to provide firming capacity to support renewable generation.

2.3. The role of exports

While AFMA and its members are primarily focused on the east coast gas market, we consider that the ability to access international gas markets has been critical to most of the recent gas investment and are keen to preserve the link between Australian and international markets. We also note LNG exports make critical contributions to the Australian economy as a source of export earnings and tax revenue and that Australian LNG exports can contribute to emissions reductions for our trading partners to the extent LNG is replacing higher emissions fuels.

AFMA therefore supports retaining a strong LNG export industry that links the domestic and global markets.

3. Impact of recent interventions

Key Points

- **Recent interventions in the east coast gas market have undermined confidence without delivering clear benefits to gas users**
- **The review should consider the extent to which current market policies support the Government's objectives**

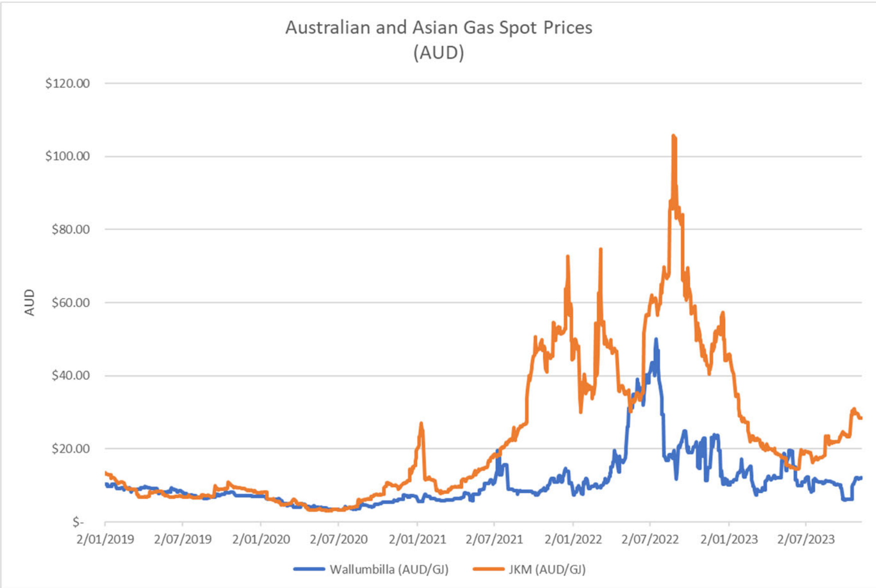
3.1. Recent policy developments

In the last 12 months there have been a number of significant policy interventions in the east coast gas market, including a $12 price cap, the Gas Market Code, reforms to the Australian Domestic Gas Security Mechanism and the introduction of new AEMO gas adequacy powers. As we pointed out in our responses to consultations on these reforms, AFMA is concerned that the various gas market policy interventions have been developed on an ad-hoc basis in isolation from each other and without

[4] https://afma.com.au/policy/submissions/2023/r48-23-cis-consultation-paper.pdf?ext=.pdf

consideration of how they will work together.[5] We think the development of the Future Gas Strategy presents an opportunity for Government to look at the role of gas more holistically and consider the appropriate policy settings to achieve their objectives.

Many of these interventions were motivated by a desire to protect gas users from the unprecedented high gas prices seen on the east coast in the middle of 2022. At the time, AFMA cautioned that the extreme high prices were unlikely to persist, and we noted that by the time the price cap was introduced in December last year, there were signs the market was correcting.[6] Asian and local spot gas prices declined for much of this year and are now at levels similar to those seen in 2021 with Australian prices well below the levels seen in Asia (JKM) (see graph below). AFMA considers that the decline in gas prices is largely the result of market forces, rather than the Government's intervention. We particularly note that; Australian gas prices peaked earlier than Asian prices largely in response to a number of outages at coal-fired generators rather than as a result of international geo-political factors, the majority of the decline in Australian prices occurred before the Government's intervention and that Asian prices have also declined during the period.



Data: AEMO and Platts (as quoted on investing.com)

AFMA consider the recent interventions in the east coast gas market have had a significant impact on investors and market participants confidence while not delivering significant benefits to gas users. We consider this review should look at the role market signals play in driving both investment and consumption decisions and investigate the extent to which current policy settings are appropriate.

[5] ADGSM - https://afma.com.au/getattachment/Policy/Submissions/2023/R01-22-AGD-Privacy-Review-Consultation-(7)/R09-23-ADGSM-guidelines.pdf?lang=en-AU&ext=.pdf
Gas Market Code - https://afma.com.au/getattachment/Policy/Submissions/2023/R01-22-AGD-Privacy-Review-Consultation-(21)/R30-23-Gas-Market-Code-Exposure-Draft.pdf?lang=en-AU&ext=.pdf
Gas Market Adequacy - https://afma.com.au/getattachment/Policy/Submissions/2023/R01-22-AGD-Privacy-Review-Consultation-(35)/R39-23-Gas-Supply-Adequacy-(1).pdf?lang=en-AU&ext=.pdf
[6] https://afma.com.au/getattachment/7cf91a6d-d243-4084-b242-e67fb83c192c/R081-22-CCA-Gas-Market-Bill.pdf?lang=en-AU&ext=.pdf

3.2. Impact on the market

While AFMA does not consider the government's interventions in the east coast gas market have had material benefits for gas users our members have observed the negative impact of the lack of certainty on the market. A number of gas projects have been on hold since the introduction of the $12 gas price cap, as suppliers and the banks providing the project financing, are uncertain of the price they will be able to get for their output. This uncertainty has continued since the July introduction of the Gas Code as the market is still waiting on Ministers to make critical exemption decisions that will allow the code to operate as designed. The continued investment delays, caused by the current policy uncertainty, mean that less gas is likely to be available to the east coast gas market to meet the current short term supply challenges than would have been available without the policy intervention.

AFMA has also observed that the interventions have reduced liquidity in longer dated weekly and monthly physical Wallumbilla Gas Supply Hub (GSH) products, which are subject to the price cap and the Gas Market Code, with buyers only able to access the short dated daily products. We understand this is largely a result of gas producers who are subject to the Gas Market Code being unable to sell longer dated gas. The reduced liquidity in longer dated Wallumbilla products has also contributed to delays in the implementation of an ASX listed physically settled Wallumbilla futures product. The reduction in Wallumbilla physical market liquidity and unavailability of futures products has reduced the ability of firms to manage gas price risk and has negatively impacted transparency by delaying the development of a credible forward price. The challenges for the futures market are discussed further in section 4.1.

AFMA is concerned that the Government's interventions in the east coast gas market to date have been detrimental to investment and have reduced participants options for managing their risk but hope that this Strategy will look at ensuring policy settings are appropriate to meet the Government's objectives.

3.3. Limited benefit to users

Much of the recent policy activity in the gas market has been motivated by a desire to ensure domestic gas users have access to a reliable supply of gas at reasonable prices, our observation is that the policy interventions have not achieved this objective. 2022 saw unprecedented spot gas prices in domestic and international markets which imposed significant costs on gas users with spot price exposure. Large gas users can manage their exposure to spot prices either by entering into physical supply contracts or through the use of financial products. These products will generally cost slightly more than spot gas but users who had used these tools to prudently manage their gas price risk were largely protected from the 2022 spot price volatility, while users who had not managed their risk were exposed to significant costs. It should be noted that small customers who purchase gas under fixed price retail contracts were also insulated from the spot price volatility. AFMA wants to stress that volatile spot prices are a feature of many commodity markets, notably including the electricity market, and that instruments such as physical or financial contracts are available to manage these risks. Users who manage this risk prudently face little exposure to spot prices, we therefore caution that spot price volatility should not justify government intervention to protect users who made poor commercial decisions that resulted in unanticipated costs.

AFMA's understanding is that the government's policy intention was to make it easier for large users to secure physical supply contracts. For this policy to be successful we would have expected to see increased contracting by large users during 2023 for both the balance of 2023 and, more importantly, for supply in 2024. The feedback from our members is that this has not occurred, with many large users remaining exposed to movement in spot prices. They cite two key reasons:

i. Continued uncertainty about the impact of the $12 price cap and the Gas Market Code has made it difficult for producers to contract to supply gas to end users.
ii. Some large users have interpreted the Government's willingness to intervene in the market as a signal that Government will always protect them from spot price increases and therefore there is no need to contract.

AFMA's view is that the unwillingness of parties to contract is a fundamental threat to the security of the gas market. Without the certainty of long-term gas contracts, producers and infrastructure providers will not invest to ensure there is adequate gas to satisfy users demands and the transportation and storage infrastructure to get it to them. AFMA considers that contracting is the best way to ensure users are able to access an adequate supply of gas at efficient prices. We suggest that the Strategy should consider the extent to which current policy is impeding contracting and Government should be clear that it will not act to protect users who fail to prudently manage their risk.

3.4. Gas market Code Review

AFMA supports the Government's decision to review the Gas Market Code in 2025 to determine if it is fit for purpose. As discussed above AFMA has serious reservations about the effectiveness of the Gas Market Code and considers that at best it has made a very limited contribution to the reductions in gas prices seen during 2023.

AFMA would like Government to work with industry to develop credible, clear criteria for the review that consider factors such as, the impact of the Code on:

- investment in new production, transportation and storage facilities
- gas users contracting behaviour
- GSH liquidity
- The development of the financial market

AFMA Recommendations

iv. The Strategy should consider if current policies are deterring investment and contracting
v. Government should increase certainty by expediting Gas Market Code exemption decisions
vi. The Strategy should make clear that gas users, not government, are responsible for managing their exposure to market prices
vii. Government should work with stakeholders to develop clear criteria for the 2025 review of the Gas Market Code

4. Gas market developments

Key Points

- **The strategy should look to promote:**
  - **the development of the gas financial market**
  - **continued improvement of the existing physical markets**

Despite the current challenges facing the east coast gas market AFMA's members remain optimistic about the development of the market. AFMA has been working with its members to identify areas for market development and considers the Strategy could play an important role in re-energising the development of the physical and financial gas markets.

4.1. Wallumbilla Futures

The ASX and AEMO have been working for some time to develop a physically delivered Wallumbilla futures product. This product will allow parties to transact a monthly listed futures product with physical delivery of the gas to occur as a monthly product in AEMO's GSH. AFMA's members support this work and consider that it has potential to both serve as an important risk management tool for market participants and to improve market transparency by providing a credible and observable forward price. AFMA understands that this product is close to being listed but our members are concerned that it may not be suitable for gas producers under the current Gas Market Code policy settings.

As discussed in section 3.2, GSH trades beyond T+3 are subject to the Gas Market Code. Our members have expressed concerns that this will result in producers who are subject to the Gas Market Code being unwilling to sell futures contracts as. Physical delivery of the futures contract must be made by selling a monthly contract into the GSH at the current market price as a result producers who have sold a futures contract may find themselves inadvertently being required to sell gas above prices permitted under the Gas Market Code or to make delivery to an LNG exporter which may not be consistent with their exemptions. As the GSH price during the period when the gas is ultimately delivered and the party that AEMO will require you to deliver to cannot be know at the time the futures contract is entered into we are concerned that the only option for producers covered by the Gas Market Code will be to not participate in the markets. As major participants in the east coast gas market producer's participation in the futures market will be critical for its success and AFMA considers that policy should support their involvement.

4.2. Gas Supply hub reforms

The development of the GSH has been one of the Government's most important contributions to the development of the east coast gas market. In addition to the direct negative impact that AFMA considers the recent interventions have had on the GSH we also consider the interventions have also had an indirect effect by distracting attention from reforms to improve it. In 2021 Energy Ministers initiated a review which proposed a number of important reforms to the GSH,[7] and at their August 2022 meeting ministers committed to submit rule changes to:

[7] https://www.energy.gov.au/government-priorities/energy-and-climate-change-ministerial-council/working-groups/gas/review-wallumbilla-gas-supply-hub-and-pipeline-capacity-trading-framework

i. enable automated, fully anonymous trading between GSH participants
ii. harmonise prudential arrangements across the Short Term Trading Markets, the Victorian Declared Wholesale Gas Market (DWGM) and the GSH.

AFMA agrees with Minister's 2022 assessment that:

> *Fully anonymised trading will encourage more on-screen trades, a higher level of price discovery for market participants, and increase flexibility and liquidity of gas markets when responding to demand and supply shocks.*

And that:

> *A streamlined approach to prudential arrangements will allow participants to net their trading positions across these markets, and only require collateral to cover their net position rather than their absolute position. Ultimately, a harmonised approach to prudential requirements for trading on these markets is expected to reduce trading costs, particularly for smaller users, and result in a more efficient and competitive east coast gas market.*[8]

Subsequent events have meant that these rule changes were not a top priority for Government and they were never submitted. AFMA considers that it would be helpful for the Strategy to refocus attention on reforms such as these that will assist the market to efficiently match supply and demand.

AFMA Recommendations

viii. Policy settings for the GSH should be adjusted to facilitate the development of the futures market.

ix. Policy makers should re-prioritise reforms to the GSH and look for further opportunities to develop the gas market.

AFMA would welcome the opportunity to discuss the Future Gas Strategy. Please contact me on 02 9776 7994 or by email at lgamble@afma.com.au.

Yours sincerely

Lindsay Gamble
Policy Director

[8] https://www.energy.gov.au/sites/default/files/2022-08/EMM%20-%20Summary%20of%20Measures%20-%2012%20August%202022.pdf