SUBMISSION

ACCC LNG NETBACK REVIEW – DRAFT DECISION | 03 AUG 2021

EUAA
Energy Users Association of Australia

Introduction and Summary

The Energy Users' Association of Australia (EUAA) is the peak body representing Australian commercial and industrial energy users. Our membership covers a broad cross section of the Australian economy including significant retail, manufacturing, building materials and food processing industries. Combined our members employ over 1 million Australians, pay billions in energy bills every year and in many cases are exposed to the fluctuations and challenges of international trade.

The current review of the LNG netback methodology is a key part of the Prime Minister's Gas Fired Recovery announcement last September[1]. It said that:

> "To better empower gas consumers, the Government will:
>
> a. Ensure Australians are paying the right price for their gas by working with the ACCC to review the calculation of the LNG netback price which provides a guide on the export parity prices"

In our earlier submission on this matter and subsequent discussions with the ACCC, we argued in particular for the ACCC to examine:

- the LNG producer netback calculation from the perspective of the buyer, not the seller, and
- the relevance of their proposed methodology to gas producers which are not LNG producers and which provide 60% of the domestic east coast gas demand.

This submission focusses on the second. We see two categories of non-LNG producers:

- Those that have a real option of selling domestically or selling to an LNG producer, and
- Those that do not have the option of exporting LNG either because of their location or business situation or because they operate leases under the Queensland Government's Australian Market Supply Condition[2].

Our proposition is that commercial reality will drive the price that non-LNG producers receive for the gas they sell to LNG producers to reflect costs greater than just the avoidable/marginal costs and include, at least to some extent, these capital costs. Non-LNG producers do not have sunk capital in LNG facilities.

The ACCC should ask non-LNG producers the same question that it asks of LNG producers – what is your next best alternative? We believe that would result in an LNG netback calculation for non-LNG producers that subtracts the capital costs of LNG process facilities and pipelines, not just the marginal/avoidable costs as is the ACCC's proposal for the LNG producers' netback calculation.

To test this proposition, we recommend that the ACCC to use its information gathering powers to obtain data on the actual prices received by non-LNG producers for contract and spot sales to LNG producers. This contract and spot price data would then be published (e.g. each as a weighted average) and compared to the LNG netback price series back to its start in January 2016.

if the data supports our proposition, then the ACCC September report should propose, for a further stage of consultation, the methodology to develop a second LNG netback measure – which we refer to as the Australian

[1] See https://www.pm.gov.au/media/gas-fired-recovery
[2] See https://www.resources.qld.gov.au/?a=109113:policy_registry/operational-policy-australian-market-supply-condition.pdf&ver=2.01

Domestic Netback Price. Offers by non-LNG producers that have a real option to sell to LNG producers for export should be reported against this second netback measure.

The concept of an LNG netback price does not apply to the second category of non-LNG producers simply because they do not have an option to export. We would propose that the offers made by these producers be compared to another price benchmark. One approach is to use cost estimates like those currently used by the ACCC Gas Reports from Core Energy or the Wood Mackenzie estimates for commercial reserves provided to AEMO as part of the GSOO[3]. They would be divided into separate reporting for Queensland and Southern States offers.

This submission supports the Draft Decision proposal to extend reporting to 5 years based on oil prices for years 3-5. We make some suggestions around transparency of the slope calculation to give C&I customers confidence in the methodology.

We are pleased to see the Commission's commitment to a further review in 2024 given how quickly markets are changing.

The purpose of the LNG netback calculation is to increase transparency for prices offered by LNG producers to the domestic market

The Draft says (p.8) that the purpose of publishing the netback prices is:

> "…to improve transparency of gas prices in the east coast gas market and to help address information asymmetry and unequal bargaining positions in the market."

and it goes on to say (p.8):

> "Our LNG netback price … represents the opportunity cost to LNG producers of supplying uncontracted gas to the domestic market rather than exporting it into international LNG markets… It is a measure of the price for uncontracted gas an LNG producer would need to receive from domestic buyers to be indifferent to supplying that gas to the domestic market or overseas markets."

What is also referred to as the 'point of indifference'. And p.9:

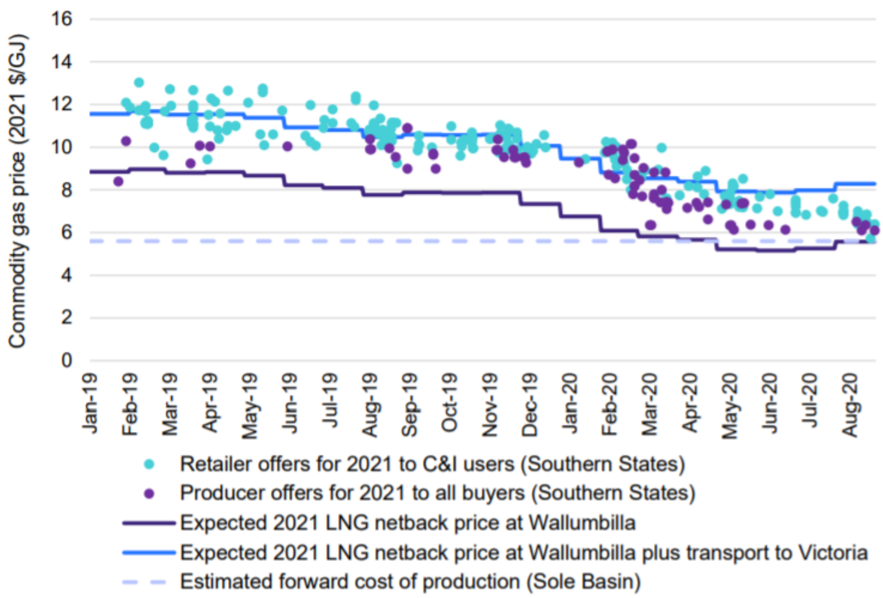
> "In a well-functioning market, we would expect LNG producers to supply uncontracted gas to Wallumbilla at prices broadly similar to LNG netback prices"

But the ACCC's regular gas reports compare all offers by <u>all</u> producers and retailers to C&I customers with the LNG netback price, not just offers from LNG producers

This chart is from the ACCC's January 2021 Interim Report (p.60).

[3] See the excel spreadsheet GSOO Reserves Resources Pipelines Assumptions in the zip file at 2021 Gas Statement of Opportunities Supply Data

Chart 3.4: Gas commodity prices (2021 $/GJ) offered by producers to all buyers and retailers to C&I users for 2021 supply against contemporaneous expectations of LNG netback (southern states)



It shows that offers made by both LNG producers and non-LNG producers (and retailers) to C&I users are all reported against the LNG producers' netback.

The Draft Decision says (p.8):

> "LNG producers supply approximately 40% of domestic demand"

leaving 60% of domestic demand supplied by non-LNG producers.

This submission focusses on what we see as the two categories of these non-LNG producers:

(i) Those which have a real option of selling domestically or selling to an LNG producer, and
(ii) Those that do not have a real option of selling into LNG either because of their location, business situation or because they operate leases under the Queensland Government's Australia Market Supply Condition

Offers from non-LNG producers that have a real option to access LNG markets and do not have sunk capex should not be compared to the LNG netback price

The ACCC's intent is to develop a measure that reflects the opportunity cost for LNG producers. The Draft refers to the measure as an 'LNG producer netback' e.g. (p.62):

> "The ACCC calculates LNG netback prices by taking the price that LNG producers can expect to receive for supplying uncontracted gas to overseas buyers and deducting any costs that are incurred to export that uncontracted gas."

We would argue that this netback measure it is not 'fit for purpose' benchmark with which to compare offers made by non-LNG producers supplying 60% of domestic gas. However, the support given by non-LNG producers to this methodology[4] and its use by the ACCC to benchmark all offers against, suggests they are happy to benefit from it. The Draft refers to non-LNG producers being able to access LNG markets by either (p.20):

- "selling gas directly to LNG producers on a third-party basis, at prices influenced by prices in export markets, which an LNG producer would then liquefy and export (or)
- entering into a 'tolling' arrangement with an LNG producer to access unutilised LNG plant liquefaction capacity, whereby an LNG producer would charge a toll to liquefy gas on behalf of another gas supplier, with that supplier then selling the LNG into export markets

We have also observed that some non-LNG producers on the east coast view selling to the LNG producers as an alternative to supplying the domestic market."

Publicly available information shows a number of significant long-term oil linked gas sales contracts have been entered into by non-LNG producers selling gas to LNG producers[5]:

Table 6 East coast gas contracts announced since October 2010

East coast gas contracts since October 2010								
Announced LNG	Seller	Buyer	Total PJ	Commences	Term (years)	Oil-linked?	Estimated price $/GJ or % oil	Delivery point
Oct-10	Santos	GLNG	750	2014	15	Yes	6%	
May-12	Origin	GLNG	365	2015	10	Yes		
Oct-12	Origin SG & Combabula	GLNG	355	2015	30	Yes		
Nov-13	Origin	QGC	30	2014	2	Yes		
Dec-13	Origin	GLNG	100-194	2016	5	Yes	7%	
Mar-14	WestSide	GLNG	445	2015	20	Yes	8.6%	
Q2 2014	Other	GLNG	25	2015	7	Yes		
Q2 2014	GBJV	GLNG	60-100	2016	21 months	Yes		
Sep-15	Senex	GLNG	260-360	2018	20	Yes		
Dec-15	AGL	GLNG	254	2017	11	Yes		
Dec-16	Armour	APLNG	9	2017	5	No		Wallumbilla
Total			**2,653-2,887**					

These sales agreements include a number of large long-term agreements that were crucial to the FID on the size of the GLNG facility given its shortage of equity gas to meet its long-term contracts shown in the next chart[6]. Sunk costs of the LNG facilities would not have been incurred had the LNG projects not been able to secure these third-party contracts. This is clearly the case with the Santos Horizon 15-year contract to supply gas to the GLNG project announced in October 2010 with Santos saying[7]:

> "Santos today announced an agreement to supply 750 PJ of gas to the GLNG project… With an oil-linked pricing formula… The gas will be supplied over a period of 15 years commencing in 2014 and is conditional on a final investment decision on GLNG train two. Santos Chief Executive Officer David Knox said the agreement delivers significant value to Santos' Cooper Basin position by opening an export channel for

[4] For example, see the submissions from Senex https://www.accc.gov.au/system/files/Senex%20Energy%20Submission%20-%20LNG%20netback%20reivew_Redacted_1.pdf and Westside https://www.accc.gov.au/system/files/Westside%20Corporation%20Submission%20-%20LNG%20netback%20review_Redacted_0.pdf

[5] Energy Quest "Energy Quarterly" March 2017 p.33

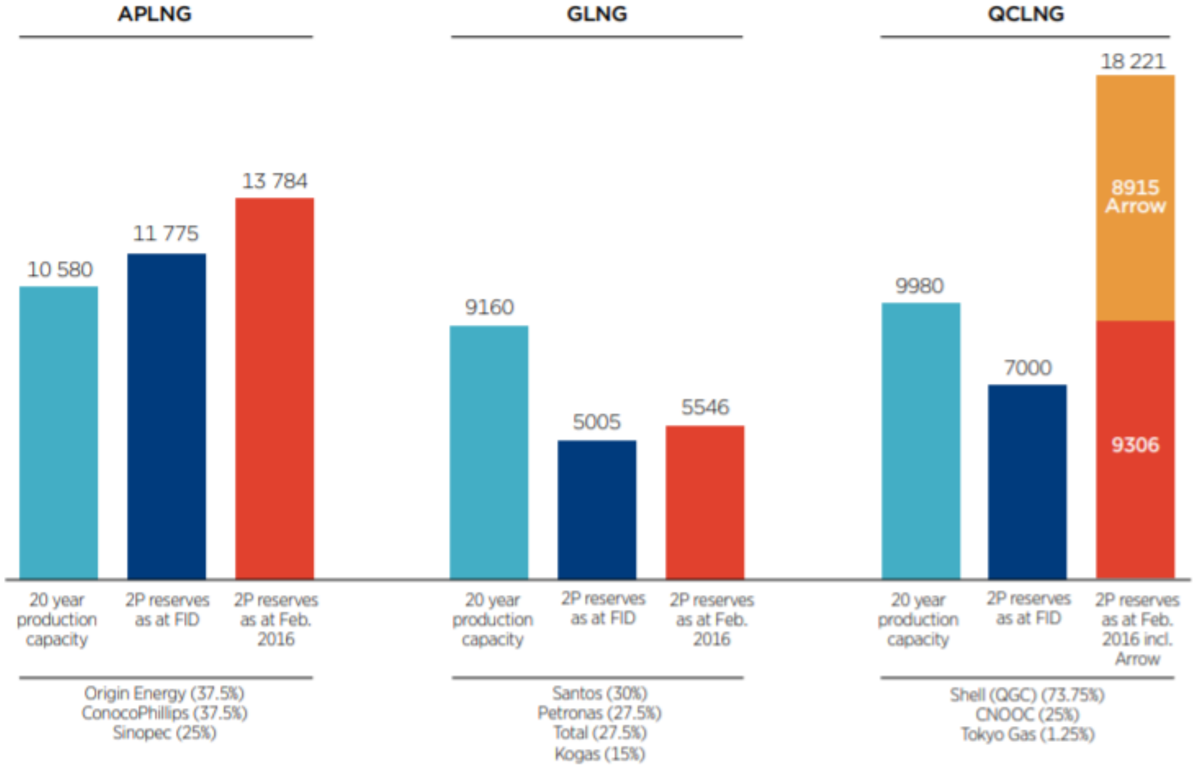
[6] ACCC "Inquiry into the East Coast Gas Market" April 2016 p. 28 https://www.accc.gov.au/system/files/1074_Gas%20enquiry%20report_FA_21April.pdf

[7] See https://www.santos.com/wp-content/uploads/2020/02/251010_santos_to_supply_750pj_of_portfolio_gas_to_glng.pdf

Cooper gas and accelerating its monetisation. 'The oil-linked pricing will underwrite future investment in the Cooper Basin and unlock the potential of the Basin's remaining substantial resources'".

It also seems to be the case with the AGL contract that on-sold gas at an oil linked priced that AGL had sourced under a fixed price contract from QGC[8].

Chart 1.2: Expected LNG plant production capacity and 2P CSG reserves of the LNG projects



There have been subsequent deals from non-LNG to LNG producers since the Energy Quest summary was published e.g. the Senex deal with GLNG in December 2017[9].

Again, on the basis of publicly available information, some of these long-term contracts also provide the ability of the non-LNG supplier to 'top-up' with spot gas sales e.g. the Armour Energy sale to APLNG[10] provided for varying volumes as production ramped up to 3.65PJ from its Kincora field. This contract also provides Armour with an option to sell domestically or:

> "…opportunistic supply when spot cargoes for LNG experience price spikes."

Westside's deal to supply GLNG seems to provide the opportunity to increase volumes though it is not clear whether this includes spot of just contract sales[11]:

> "The development of the Meridian Field is underpinned by a 20-year gas supply agreement to sell gas to the GLNG-project at oil-linked prices. Gas has been sold into the GLNG contract since 2015 and the agreement provides Westside with long-term security and a flexible path to expand production at the Meridian Field."

[8] Angela Macdonald-Smith "How AGL Energy got caught out on gas" Australian Financial Review 18th June 2018 https://www.afr.com/companies/energy/how-agl-energy-got-caught-out-on-gas-20180618-h11iox
[9] See https://www.senexenergy.com.au/wp-content/uploads/2017/12/2017.12.21-Senex-sells-Phase-2-gas-to-GLNG.pdf
[10] See https://wcsecure.weblink.com.au/pdf/AJQ/01815683.pdf
[11] See https://www.westsidecorporation.com/our-projects/

The ACCC should apply the same methodology it applies to LNG producer netback to the non-LNG producer netback - what is the price a non-LNG producer would need to receive from domestic buyers to be indifferent to supplying that gas to a domestic or export market? What is the non-LNG seller's next best alternative?

Our proposition is this - intuitively we would expect commercial reality to ensure that that any sale of gas from a non-LNG producer to an LNG producer would be at a discount to the price the LNG producer would receive from selling that gas. We would also expect that this discount takes into account the capital and operating costs associated with the delivery and processing of that gas for export. We would find it very surprising that an LNG producer would charge the non-LNG producer only the marginal costs associated with exporting the non-LNG producer's gas.

The limited evidence from Energy Quest above shows a sale price slope of 6% (Santos) 7% (Origin) and 8.6% (Westside), all of which are well below their estimate of the average slope of 13.85% for oil-linked LNG contracts[12]. This is a much higher discount than can be explained simply by operating/avoidable costs. Armour's 2020 Annual Report shows that the average gas prices received in 2018/19 ($6.06/GJ) and 2019/20 ($6.10/GJ)[13] which seems to be predominately, if not completely, Kincora sales to APLNG in the first two full years of deliveries under the contract.

Therefore, we propose that the ACCC use its information gathering powers to obtain detailed time series data on the actual volumes sold and prices received by non-LNG producers (including the domestic arms of the LNG producers Origin and Santos) for sales of contract and spot gas to LNG producers. This data may then need to be adjusted for particular contract characteristics e.g. oil linked prices received may lag actual oil prices, and then compare each series with the LNG netback series since it started in January 2016.

This comparison would:

- cover both long-term contract sales and any additional sales above original contracted volumes, and
- be disaggregated into volumes/prices for original contract volumes and volumes/prices for additional term/spot sales.

If our proposition is confirmed then we propose that the ACCC develop a second LNG netback calculation against which to report price offers for non-LNG producers that have the option of exporting gas. This second calculation, which we refer to as the 'Australian Domestic Netback Price', would deduct the capital costs of the LNG plant and any pipeline transport to get the gas to Gladstone. We think that use of this second netback series will considerably help the development of a 'well-functioning market' and support better achievement of the ACCC's objective:

> "…to improve transparency of gas prices in the east coast gas market and to help address information asymmetry and unequal bargaining positions in the market."

The concept of an LNG netback price is irrelevant to non-LNG producers that do not have the option or the ability to access LNG markets

We would suggest that there are two categories here:

- Southern State producers, and
- those covered by the Queensland Government's Australian domestic market supply condition.

At the outset we would comment on what the 'option to sell domestically into LNG' should mean in practice. We would argue that it can only be a 'real' option, not a theoretical one.

[12] Energy Quest op cit p.31

[13] Armour Energy Ltd "Annual Report Year ended 30 June 2020" p.20 https://wcsecure.weblink.com.au/pdf/AJQ/02302649.pdf

While we noted the ACCC's comment above:

> "We have also observed that some non-LNG producers on the east coast view selling to the LNG producers as an alternative to supplying the domestic market."

A non-LNG producer having a 'view' to selling to an LNG producer as an alternative, is a long way from actually doing so. We do not consider a simple statement from a non-LNG producer to an EUAA member along the lines of:

> "If we do not sell to you, we can sell to an LNG producer."

to be sufficient to be relevant in this discussion. The non-LNG producer should be required to prove that it currently has the capacity to do so e.g. full terms standing agreement(s) with an LNG producer, in house capacity for trading and is actually doing so. Senex sees its 'limited spot price exposure' as a benefit to investors[14] with its Cooper Basin production fully contracted on fixed prices and 95% of its Atlas gas contracted at fixed prices in 2020[15].

We question whether Southern State producers have a real option to sell into LNG. Perhaps there is an option through the AEMO pipeline trading capacity mechanisms but we are unsure about how reliable that would be to supply gas to Wallumbilla. Perhaps some Southern States producers have enduring arrangements to supply gas to Wallumbilla and do not have to rely on capacity trading.

Again, it would be easy for the ACCC to use its information gathering powers to show whether Southern State producers have sold any gas to LNG producers since the GBJV deal in 2014 cited in the Energy Quest data above.

This will confirm or otherwise Energy Quest's conclusion[16]:

> "In the long term, Victorian producers are likely to be able to get higher prices from selling gas into Sydney and Adelaide than exporting it to Queensland, based on the plots above."

If there is little or no evidence then surely that indicates that any claim by these producers that they can sell to LNG producers, (that seems designed to extract a higher price from C&I users), is not sustainable. This lack of an option to export should be recognised by the ACCC in its reporting by not including offers by these producers in their comparison with the Australian Domestic Netback Price.

To do so would work against the ACCC's objective to:

"…help address the information asymmetry and unequal bargaining position in the market" that EUAA members face.

The Draft Decision makes no reference to the latter category producers using the special Queensland Government leases. The granting of these leases by the Queensland Government requires that gas produced[17]:

> "…be sold or supplied only to the Australian market and that any contract or other arrangement for the sale or supply of gas, must include a condition that further sale or supply of the gas may only be to the Australian market…

[14] Senex Energy "Senex delivers transformational growth through its Surat Basin investments" Slide 18 ASX Announcement 11th March 2020
[15] Ibid Slide 22
[16] Op cit p.31
[17] See https://www.resources.qld.gov.au/?a=109113%3Apolicy_registry%2Foperational-policy-australian-market-supply-condition.pdf

In some circumstances, the Minister has included an additional condition on producers subject to the AMSC. This additional condition requires that any gas produced from the PGPLR land must only be supplied to an Australian manufacturer…"

Comparison of offers from these two non-LNG producer categories should not be with an LNG netback price – whether it is for LNG producers or the Australian Domestic Netback Price. It should be with some benchmark of efficient costs. We have some information on what costs are from various company reports.

For example, for Senex[18]:

> "Unit operating costs <$3/GJ (all-inclusive cost, including field operating costs, tolls, tariffs and royalties)"

One approach is to use cost estimates like those currently used by the ACCC Gas Reports from Core Energy or the Wood Mackenzie estimates for commercial reserves provided to AEMO as part of the GSOO[19]. Reporting would be divided into separate reporting for Queensland and Southern States offers.

Reporting by the ACCC of offers by non-LNG producers against the LNG producer netback is working against the ACCC's objectives on increased transparency and addressing information asymmetry and unequal bargaining positions

It is interesting to examine the arguments proposed by Senex in its submission on the Issues Paper. Senex sells to both LNG producers and the domestic market, with some of its latter sales from leases allocated under the Queensland legislation discussed above[20]. In its submission to the ACCC review[21] it argues that for producers like itself:

> "…to survive and continue to invest over the long term, gas prices through the cycle must be sustained at a level that delivers the necessary returns.

It says that given the purpose of the ACCC netback series is provide a reference price for LNG producers, the:

> "LNG netback price series is of limited relevance to domestic focussed gas producers…we do not export and we do not have such a 'point of indifference'… Because the east coast market is our only market, Senex needs to secure from that market a price that reflects the supply and demand fundamentals of the market, and appropriately compensates us for the investment we have made (or could make), and the risk we have taken (or could take). (p.3)

Yet Senex supports the existing netback methodology of not deducting capital costs. We would suggest that one reason may well be found in the ACCC's recent report on its review of producers pricing strategies. While Senex claims in its submission:

> "The apparent 'point of indifference' for an LNG producer, as estimated by the ACCC LNG netback price series, is sometimes noted in our price discussions with customers and in our internal considerations but is often irrelevant."

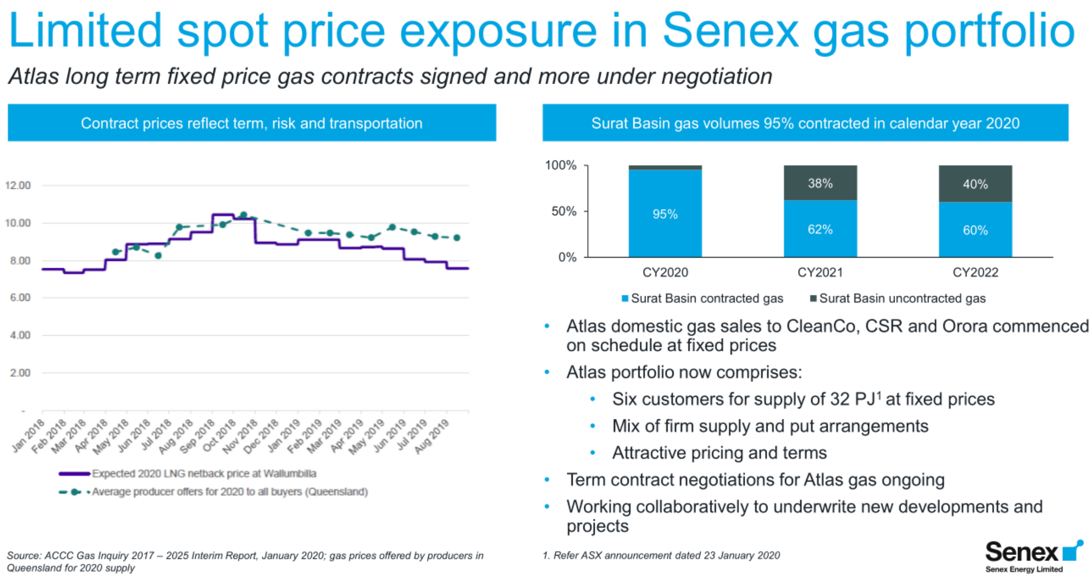
18 Senex op cit Slide 28

19 See the excel spreadsheet GSOO Reserves Resources Pipelines Assumptions in the zip file at 2021 Gas Statement of Opportunities Supply Data https://aemo.com.au/en/energy-systems/gas/gas-forecasting-and-planning/gas-statement-of-opportunities-gsoo

20 See https://www.senexenergy.com.au/wp-content/uploads/2017/09/2017.09.05-Senex-awarded-Surat-Basin-acreage-for-domestic-gas-supply.pdf

21 https://www.accc.gov.au/system/files/Senex%20Energy%20Submission%20-%20LNG%20netback%20reivew_Redacted_1.pdf

this does not accord with what Senex seems to be representing to its shareholders. This slide from a March 2020 Investor Briefing[22] seeks to compare prices received under contracts from its Atlas field with domestic users (fixed + CPI) with LNG netback prices. Yet Atlas is a lease allocated by the Queensland Government under the Australian domestic market supply condition[23].



Also, this does not accord with the ACCC's view based on a review of confidential gas producer company documents. The key problem for consumers is highlighted by the ACCC (p.21):

> "Our recent examination of the pricing strategies of key domestic suppliers confirms that LNG producers, *and other gas producers*, on the east coast consider LNG netback prices when forming views about prices in the domestic market." (*emphasis* added)

Further, the ACCC concluded in its January 2021 Interim Report[24]:

> "…our early review of suppliers' pricing strategies material suggests competitive dynamics have only been a limited constraint on gas prices over the past few years. We found only limited references by suppliers to the pricing behaviour of competitors. Based on our experience in other sectors and our competition enforcement and mergers work, we would expect to see this in a well-functioning market.
>
> This supports a degree of caution in welcoming more recent signs of competition in the east coast market, and has influenced our concern that these improvements could be tenuous."

We would suggest that the current LNG netback calculation methodology can provide significant headroom for non-LNG suppliers that do not have a real export option in their price negotiations. They know they will not be faced with competition from LNG producers because of the LNG producers' 'point of indifference'. Both LNG and non-LNG producers are able to utilise the LNG netback number.

[22] Senex Energy op cit Slide 18
https://www.senexenergy.com.au/wp-content/uploads/2020/03/2040406.pdf
[23] See https://www.senexenergy.com.au/operations/project-atlas/
[24] ACCC Gas Inquiry 2017-25 Interim Report January 2021 p.14 https://www.accc.gov.au/system/files/Gas%20Inquiry%20-%20January%202021%20interim%20report_3.pdf

Senex does not need to refer to the LNG netback price in negotiations because buyers are now conditioned to expect that the LNG netback price will be the floor for negotiations. The regular ACCC Gas Reports consistently show offers and realised prices above the LNG netback price point.

We do not consider non-LNG producers utilising leases that allow them to export and being able to appropriate the LNG producers' netback at a floor price as evidence of a well-functioning domestic market. As we noted in our submission on the Issues Paper:

> "Sellers (here referring to non-LNG producers) extract rents simply because they have the market power to do so."

We support the proposal to publish longer term LNG netback prices extending to 5 years, based on an oil-linked index.

This would apply to both the existing LNG producer netback price series and the Australian Domestic Netback Price series to address information asymmetry. We agree with the challenges in getting data on the percentage slope for this longer period and the risk that the oil price measure may be above the JKM measure and this oil based measure becomes the floor price in negotiations.

We would suggest that the ACCC use a combination of the proposed annual consultant assessment of the forward-looking slope plus with the following data points to increase the transparency of that slope calculation to C&I users:

- Use the information gathering powers to obtain data on what LNG producers actually receive and provide this data to the consultant who is bound by a confidentiality agreement
- Publish this historical data as a weighted average slope for all three LNG producers
- Examine over time the forecasting performance of the slope chosen for the extended netback price and publish the results

Thank you for the opportunity to make this submission. Do not hesitate to be in contact should you have any questions.

Kind regards,

Andrew Richards
Chief Executive Officer