SUBMISSION

GAS MARKET PARAMETERS REVIEW | 7 OCT 2022

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.

Our membership covers most of the major electricity and gas users in the east coast gas market who all rely on reliable and competitively priced electricity and gas for their business sustainability. We are interested in the gas market parameters for their impact on both the gas and electricity markets, particularly as it played out during June. There the gas market parameters allowed a significant wealth transfer from electricity consumers to gas producers and this was cemented in the rules with the recently released AEMC's Draft Decision on the NEM APC. The timing for the review of the gas cap is unfortunately after the electricity APC, rather than before.

Our members have had firsthand experience of the dysfunctional east coast gas market that has been highlighted by many recent ACCC gas reports eg dramatically rising prices particularly in the last 12 months, lack of competition for supply, significant fall in the availability of supply from Bass Strait, various State government restrictions on new gas development and pipeline owners potentially exercising monopoly power. We are also well aware of the need to decarbonise the energy supply chains and the impact of polices like the Victorian Gas Substitution Roadmap.

While members generally rely on term contracts for their supply, a number do operate in the various trading markets that are the subject of this review. We recognise the important role AEMO plays in ensuring the efficient operation of the gas trading markets, particularly in an environment where various stakeholders may be able to exercise market power.

This submission on the Market Reform Draft Consultation Report ('Report'), discusses three areas:

1. the modelling methodology - we submit that the apparent assumption of a competitive market does not reflect the market our members see and which the regular ACCC Gas Reports describe; modelling of parameter settings needs to take market failure into account
2. the potential impact of the recently announced gas market powers to be given to AEMO ahead of winter 2023 on market parameters
3. scenarios – we propose some extension to scenario 13 to better reflect the current gas market

Only a few of our members are active in the spot gas markets because they cannot rely on its supply security and volatile pricing. The same uncompetitive behaviour by producers in the contract market also influences the spot market. We are concerned that the recent significant increase in prices driven by external events and the behaviour of producers during June, will lead to a rise in the level of the market parameters based on a modelling methodology that seems to assume a competitive gas market. The huge wealth transfer that occurred in June and July from consumers to producers will only increase and inevitably lead to demand destruction.

1. Modelling methodology

Perhaps the most surprising aspect of the Report is the lack of discussion of the uncompetitive east coast gas market. The ACCC has been highlighting this in all of its Gas Market reports since 2015. For example, the latest (August 2022) concluded[1]:

- Recent events across the east coast gas and electricity markets have shown the consequences of having insufficient gas supply to meet domestic demand and ineffective upstream competition.
- Supply conditions are expected to deteriorate further in 2023, with a shortfall of 56 PJ now expected. This is expected to occur against the backdrop of a highly concentrated upstream market, with competition posing little constraint on the behaviour of producers.
- Ensuring there is sufficient supply in the east coast gas market both immediately, and over the longer term, is critically dependent on measures to improve competition and encourage the timely supply of gas.

This is a result of a combination of factors – State Government policy restricting development of new gas sources which has supported the ability of existing producers to exercise market power.

The implicit assumption in the Report seems to be that the market will respond in a competitive way to the signals that the market parameters send. The Report notes (p.33):

> “An underlying assumption is that the market is in equilibrium, such that supply and demand is aligned with the prevailing typical level of gas prices.”

Section 4 discusses the ‘trade-off between market efficiency and market risk’ in the way that suggests the concept of market efficiency is possible in the spot market. It is certainty not possible in the contract market and the Report provides no basis for supporting it to be able to be achieved in the spot market. The fact that the market might clear at a high enough price is no indication of an efficient market. It might be in equilibrium, but it is a long way from competitive equilibrium.

The graphs in Figure 5 correctly describe the theory but bear no resemblance to what is happening in the gas market (whether contract or spot). We see no evidence of a conventional smooth upward sloping supply curve in June when gas was flowing north from Victoria and there was often spare capacity to flow south to alleviate the very high prices in Victoria. It seems LNG producers preferred to make spot sales. The MCE decision to give AEMO significant directions powers from winter 2023 indicates Ministers also consider the market to be uncompetitive.

While the theory of Case A suggests maximising consumer and producer surplus, that is not what is happening in practice. Most if not all consumer surplus now goes to producers given recent contract prices. Consider the Report’s description of Fig 6 B:

> “Case B illustrates the impact of capping the market price below the price where the market would otherwise clear. Suppliers have little incentive to supply gas which costs more to deliver than the capped market price allows or on which they cannot earn a profit, so the total quantity of gas made available may be restricted. While the consumers actually supplied benefit from a lower price, the reduced gas supply

[1] See p. 93 https://www.accc.gov.au/system/files/ACCC%20Gas%20Inquiry%20-%20July%202022%20interim%20report%20-%20FINAL.pdf

> means that the sum of consumer and producer surplus is lower and market efficiency is reduced. A higher price cap will tend to alleviate this problem and improve the total surplus."

The theory of maximising total surplus assumes a competitive market. We would submit that setting the market parameters needs to acknowledge the uncompetitive market and wealth transfers that are occurring in the spot market from consumers to producers. The lack of competition in the domestic market means that even if the capped market price was set at a level that the producer makes a profit (which would be below the LNG netback price) in the absence of any external direction (Government or AEMO), gas supply may be insufficient.

The higher the capped market price the less profit an industrial customer makes – and the less likely a customer is going to buy the gas because they are making a loss. Many domestic industrial customers would be making a loss at current LNG netback prices. Some may make a cash profit but cannot sustain operations for any length of time at these prices.

The AEMC Draft Decision to increase in the electricity APC to $600/MWh in response to the current gas APC simply allows gas producers to lock in that wealth transfer. The risk of higher market parameters is not borne by gas fired power stations but by electricity consumers.

We doubt that historical ABS data is a useful guide to assessing sector profitability data for all C&I for the next 5 years. So we are not convinced that 500 days is the appropriate measure. While some industrial customers have the benefit of longer-term contracts done prior to the recent large increase in prices, indications from our members are that the number of these contracts will fall off considerably in the next couple of years and so industrial customers will be exposed to considerably higher gas prices in the near future.

We would be happy to facilitate discussions with our members to assist Market Reform to better understand the expected situation.

We doubt the use of an import LNG facility as a guide as we do not see it ever occurring. A number of our members have been approached to sign offtake deals with the Port Kembla LNG plant. None have been completed simply because the proposed price is uneconomic for our members. In the absence of some form of Government offtake guarantee LNG import projects will not proceed.

2. Upcoming future market design changes

The Report refers to these at p.20, though it was prepared prior to the release of details of the proposed changes[2]. After mentioning a couple of AEMC changes, the Report says that:

> "We have not identified any need to specifically account for these changes in the gas parameter review which focuses on market clearing prices."

We would submit that the detail of the proposed AEMO powers around directions[3] means that it could have significant impacts on the various parameter settings. AEMO is to have wide ranging powers that enable it, in the

[2] Released on 26th September https://www.energy.gov.au/government-priorities/energy-ministers/priorities/gas/proposed-regulatory-amendments-extend-aemos-functions-and-powers-manage-east-coast-gas-supply-adequacy

[3] See https://www.energy.gov.au/government-priorities/energy-ministers/priorities/gas/proposed-regulatory-amendments-extend-aemos-functions-and-powers-manage-east-coast-gas-supply-adequacy

absence of market action, to direct the market in any way it thinks is required to ensure gas system reliability and supply security. This suggests this review should consider what the exercise of these powers might have on the setting of the parameters. For example, given AEMO's directions powers, what is the NGO benefit of setting the APC at any level above the price at which most producers cover their short run costs?

This is the methodology used by the AEMC in its decision on the Alinta rule change – what electricity APC means that most gas generators cover their gas costs at $40/GJ. It seems perverse that the APC would be set at a level where producers (which in practice would be dominated by LNG producers given the rundown in Bass Strait production) would supply the domestic market rather than the LNG spot market ie some estimate of the forward LNG netback price given the APC 'acts to limit the financial risk of consumer' (p.36)? If the market does not respond to an AEMO efforts to produce a market response, then AEMO simply directs producers to supply at an APC that covers their short run costs.

3. Scenario options

We would suggest consideration of an expansion in Scenario 13 and a new scenario 14.
The event description of Scenario 13 is - 'External events cause rapid rise in international commodity prices driving high prices in Australia coinciding with high gas demand.' starting from 2026.

- That external shock is happening now so it should start now
- Do not understand why it is assumed electricity prices are uncapped
- It could consider an option where industrial demand collapses

A suggested Scenario 14 would cover the situation where AEMO exercises its direction powers as the 'event' with that happening from Winter 2023.

Concluding comments

A final comment on engagement process. The website has the following process:

Review Timetable

Stage	Date
Gas Wholesale Consultative Forum (GWCF Workshop)	8 September 2022
Initiation of Consultation	15 September 2022
First round of feedback due	7 October 2022
Draft Decision	1 December 2022

It seems that those making submissions will have no opportunity to see what impact their submissions will have had on the methodology to be used by Market Reform. We would recommend the addition of a step allowing presentation and discussion of the final methodology prior to the modelling actually starting.

Once again, 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