13 December 2022

Gas Market Consultation
Labour Market, Environment, Industry and Infrastructure Division
The Treasury

Submitted by email: gasmarketconsultation@treasury.gov.au

Dear Sir/ Madam,

Gas Market Bill Consultation

The Australian Financial Markets Association (AFMA) is responding to the Treasury's consultation on the *Competition and Consumer Amendment (Gas Market) Bill 2022* (the Bill).

AFMA is the leading industry association promoting efficiency, integrity and professionalism in Australia's financial markets. AFMA has more than 125 members reflecting a broad range of participants in Australia's financial markets, including energy companies who are key participants in Australia's energy markets.

Global energy markets are currently experiencing severe disruption which is causing significant pain to energy users. This disruption has led to an understandable desire for extraordinary intervention in an attempt to temporarily cushion the impact to the Australian economy and Australian consumers while the global gas market adjusts to the current conditions. AFMA appreciates the intention behind the 12-month price cap under the pricing order; but is concerned about the long-term impact on the market of price regulation under the mandatory code of conduct (the Code). Our submission therefore principally deals with the impact of the Code on the function of the gas market, and also highlights some potentially unintended consequences of the price cap.

In relation to the Code, AFMA is concerned that the empowering provisions in the Bill supporting the Code, set conditions for ongoing regulation of domestic gas prices and do not contain a framework for ending the intervention or formally reviewing its effectiveness. We are concerned that this approach will increase uncertainty in the gas market and reduce investment in projects intended to supply the domestic market, ultimately harming consumers, businesses and the wider Australian economy.

AFMA recommends the following changes to help alleviate these concerns:

i. The Bill should include a provision for regular formal reviews of the impact and effectiveness of and ongoing need for the intervention
ii. The Bill should also include a clear mechanism for ending the "reasonable pricing" obligations

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iii. The mechanism should be based on measurable criteria indicating the end of the circumstances that justified the intervention

iv. To the extent that price regulation is required after the initial 12 months, it should be based on external pricing benchmarks rather than individual producers' costs

We note that many of the key elements of the package concerning the Code are contained in the Bill and that only an extremely brief period has been allowed for consultation. This is particularly inappropriate as the key pricing elements of the Code are not intended to apply until 2024.

1. Role of the market price

Natural gas is an internationally traded commodity whose price is determined by a range of international factors. Investment in gas production is characterised by long term projects with high upfront capital costs, a high-risk profile and cyclical revenues determined by the global market. The large-scale investment in the east coast gas market over the last decade has been driven by the prospect of being able to access these global prices. These investment decisions have underwritten east coast gas supply as older conventional fields have declined. The investors in these projects expected volatile returns linked to the commodity cycle, with periods of low or negative returns balanced by periods of higher returns.

While recognising the case for a temporary price intervention in the gas market, AFMA is concerned that the price regulation provisions of the Code are anticipated to be an ongoing feature of the gas market. Price regulation in general is expected to limit the effectiveness of the market signals provided by prices, deter investment, encourage inefficient use of gas and have a negative impact on participants who have managed their risk through derivatives or other instruments. However, we are especially concerned that the proposed approach to determining a "reasonable price" would be particularly detrimental in the gas market. The approach set out in the consultation paper appears to be based on the type of regulatory approach that the AER or ACCC would use to determine the return on regulated monopoly infrastructure. This approach is appropriate for low-risk monopoly assets that enjoy certain returns, do not face competition and have a low cost of capital — but is not appropriate for higher risk investments in commodity markets.

East coast gas producers have varying production and capital costs but have all justified their investment decisions based on the opportunity to receive variable market prices for their gas. During periods of low gas prices, as occurred during much of the 2010s, many producers made low or no profits. Their investments were justified by the prospect of higher returns during periods of high prices. The proposed approach to determining "reasonable prices" is inappropriate in the gas market as it would provide no protection to gas producers against the risk of low prices but would prevent them from capturing offsetting profits from periods of higher prices. This is likely to deter investment in assets intended to supply the domestic market.

Additionally, it is unclear how the proposed asset based regulatory approach is intended to work in the gas market where producers can face markedly different production costs and therefore would potentially be able to charge different prices. It is not problematic for monopoly assets to charge different prices for similar services as they do not compete with each other, but it is more challenging in a tradable market like gas, where prices are generally determined by the marginal producer. Basing returns on a producers' costs reduces the incentives for low-cost producers to expand output and all producers to pursue efficiencies that could lower their costs. We anticipate in the long term this would lead to reduced supply and, in turn, increased prices. Reduced supply and higher prices cause direct harm to consumers and businesses.

2. Need for an exit mechanism

Markets require clear signals to function effectively. The Bill and the consultation paper do not provide clarity about the future direction of the gas market, which is particularly important given the role gas is expected to play in Australia's energy transition. The consultation paper indicates that the Code will be "an ongoing addition to Australia's east coast gas market regulation" but that the Code will be "reviewed on the basis of changes to the market's structure and conduct." While the "reasonable pricing" obligation "is expected to remain as long [as] required, and until the ACCC advises the Government that domestic gas prices are reflective of the underlying costs of production and that there is sufficient supply at these prices" but "the operation of this provision will be considered as part of a review of the broader code, once it has been in place for a year." Meanwhile the Bill does not provide for any review of either the Code or the "reasonable pricing" provisions and whether the Code is assisting by underpinning supply and allowing for a smooth energy transition to renewables.

Australia has, rightly, moved away from regulating generic commodity prices on the basis that market prices and price risk management, are the most effective way to encourage investment in and efficient use of commodities. While the current circumstances make a temporary price intervention in the gas market understandable; AFMA considers that long term price regulation is likely to ultimately be unsuccessful and that policy makers should ensure that there is a clear process for ending the intervention.

The global gas market is already adapting to the current geo-political circumstances with significant new investment in LNG projects globally. As a result, the dynamics of the global market are likely to change considerably in the coming years with potential even for low global prices driven by an LNG glut. AFMA recommends that the Bill should contain provisions for regular formal reviews of the effectiveness of and continued need for the intervention based on changes in the global gas market. We recommend that there should be a review conducted prior to the end of the price cap period, to determine if there is a need for further price intervention, and then every 12 months until it is determined that price regulation is no longer required.

3. Market implications of the price cap

While AFMA appreciates the motivation for introducing a temporary price cap, we want to point out some potentially unintended consequences of the cap in the gas spot and derivative markets that we anticipate will have an impact on the ability of gas users to manage their risk. The Wallumbilla Gas Supply Hub (GSH) has developed as an important trading hub allowing gas market participants to manage their risk. We are concerned that imposing a price cap on producers' GSH trades will diminish liquidity and reduce the markets' ability to efficiently allocate gas. We assess that this could be particularly problematic for gas fired generators who use the GSH to buy gas at short notice to meet peak electricity demands. For example, when prices are high in the NEM gas fired generators may be willing to pay a premium for short term gas to allow them to run in response to the high NEM prices. Capping the price that producers can sell at in the GSH is likely to reduce their incentive to incur the additional operational cost of supplying gas on a very short term basis, meaning that less gas is likely to be available to generators.

We are also seeing evidence that the proposed price cap is reducing liquidity in derivative markets based on the east coast spot markets. These markets are increasingly important risk management tools for small gas retailers, and we are concerned that they will face increased spot price risk if they are unable to access gas derivatives and therefore may be less able to manage their risk. We also note that the physically settled Wallumbilla gas futures product, that the ASX, AEMO and market participants have spent the last 24 months developing; is unlikely to be successful in the current environment.

AFMA would welcome the opportunity to discuss Treasury's wholesale gas market work. Please contact me on 02 9776 7994 or by email at lgamble@afma.com.au.

Yours sincerely

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Policy Director