GRATTAN Institute

The wholesale gas market is worth saving

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Overview

Global oil and gas companies are reporting record-breaking profits, driven primarily by war-related disruptions to the global energy market, most notably gas. The underlying assumption of an effective market delivering more supply is simply not working, and the consequences are horribly high costs for businesses and households across the world. Australia is no exception.

Government failure to act is socially, economically, and politically untenable. Yet governments such as the UK, Germany, and the US have struggled to find an effective answer that would re-balance the abnormally high prices and profits until 'normal' market conditions return. Solutions have included windfall profit taxes, fixed prices to designated customers, and price caps. This is a very difficult intervention to get right.

The Australian government adopted the last of these options in the form of a headline $12 per gigajoule price cap. This was probably the best next step among some hard alternatives, but the industry and the ACCC are still struggling with its practical implementation in a complex market.

But it got worse. The immediate challenge of windfall profits became conflated with a second issue: the view of the ACCC that the east-coast gas market suffers from systemic issues, primarily due to concentrated market power. Possibly frustrated by recalcitrant LNG producers, the government has accepted that view and intends to introduce a mandatory code of conduct, the central element being a reasonable-price provision, with the test of reasonableness based on long-run marginal costs.

The government's proposal is a dramatic move with very difficult challenges and no obvious pathway back to a workable market. The industry seems stuck in its own rhetoric that fails to recognise that political momentum and public sympathy are with the government. It should not have come to this.

There are three possible ways out. The mandatory code could become a form of economic regulation based on costs. The nature of the industry makes this almost certainly unworkable.

The government's preferred model looks to be a mandatory code with the threat of arbitration based on long-run marginal costs being enough to drive both producers and customers to commercial agreements. It would be nice to believe this is viable, but it will depend on goodwill from both sides, a commodity presently in short supply.

A third alternative could be one based on a pathway back to a functioning market, recognising that Australia's wholesale gas market is always likely to be relatively concentrated. The core of this approach would be to retain a price cap, possibly indexed beyond the current 12 months, with the ACCC given the task of determining when LNG netback prices reflect a functioning market and the price cap could be removed. Again, mutual compromise would be required, but the longer-term outcome might be worth the effort.

The government's first measure was appropriate and timely. A second measure is necessary, but the longer-term consequences suggest considerably more work is needed on the current proposal.

1 Assessment

This submission is made by Tony Wood, Alison Reeve, and Esther Suckling from the Energy Program at Grattan Institute. Grattan Institute is an independent think tank focused on Australian domestic public policy. Grattan aims to improve policy by engaging with decision-makers and the community.

In December 2022, the Department of Climate Change, Energy, the Environment, and Water released a consultation paper: 'Options to ensure the domestic wholesale gas market delivers for Australians'. This submission addresses the issue of a mandatory code of conduct with a reasonable-pricing provision, and the related questions raised in the consultation paper.

The consultation paper assumes that this is the only option being considered by the government. In this submission, we raise several important questions about and challenges with that position and suggest that it be reconsidered. However, our answers to the questions in the consultation paper assume that the government proceeds with the core principles and design of the code of conduct. We have not answered all of the questions in detail.

1.1 Background

Based on its public position, we have assumed that the government envisages temporary intervention and is not intending to permanently replace the wholesale gas market with economic price regulation. Accordingly, our central concern with the mandatory code is that it seems to create significant barriers to this outcome. This submission is intended to address those barriers.

It seems that both the government and the gas industry have reached positions that make a good outcome hard to achieve. The industry refused to accept that the announced price outcome expectations were simply unacceptable for the government and seems to think they can win the public debate again. They are probably wrong.

If the government had announced the 12-month price cap with a simple extension methodology, the industry would have probably found a way to acceptance. The government could even have made it clear that further action might be necessary without prescribing it in the way they have. A literal reading of the consultation paper suggests instead that the government has reacted to an ACCC position that the market is not workable and needs a stronger, more direct intervention. This seems like a potential contradiction. Even though the public language from the government suggests that the arrangement will be temporary, the criteria for the 'reasonable pricing' provision to be lifted is a very high bar and arguably hard for the ACCC to impose.

The primary issue is the concept of a reasonable price reflective of the underlying costs of production. It's obvious that the current spot prices are not reflecting that. Effective markets are usually expected to do the job, but the current market is being distorted by global demand. Setting a price cap or windfall profit tax based on the prices that existed before the Ukraine war and keeping it there with some adjustment mechanism would have been a better idea.

The addition of the reasonable-pricing provision sounds remarkably simple and attractive. But difficulties arise when contemplating how to turn a nice-sounding idea into a practical instrument based on cost elements as set out in the consultation paper.

Calculating the long-run marginal costs of domestic supply of any sector is hard enough, even for a regulated monopoly such as a distribution network. It seems almost impossible for the regulator to

determine efficient operating expenditure, including for new supply. Determining risk premiums for gas exploration and development and assessing the economic life of new developments when there is so much uncertainty about climate policies are issues normally left to investors and their financiers to determine and markets to price.

Different suppliers will have very different cost bases, so the reasonable price would be very different depending on the circumstances. Prices usually emerge from the market dynamics, and the paper seems to suggest that each contract would be subject to negotiations, with the reasonable price providing some sort of reference point. This makes the concept fundamentally different from a market with largely homogeneous costs such as electricity retailing, and even there, concepts such as determining reasonable hedge contracting and reasonable customer acquisition and retention costs are difficult to quantify. Economic regulation of natural monopoly businesses such as electricity and gas distribution networks has evolved highly complex methodologies for assessing the multiple elements that constitute an acceptable return on capital in a low-risk environment.

One example that could provide a basis for consideration is the current approach to transportation contracts on Australia's gas transmission pipelines. Even though these assets have the characteristics of natural monopolies, the current arrangements of shipping contracts with a compulsory arbitration backstop seem to work well enough for owners and shippers to avoid a reversion to regulatory coverage. In this case, presumably, the pipeline owners have been persuaded to offer acceptable prices to shippers to avoid a worse outcome through arbitration or economic regulation. The key difference with the wholesale gas market is that gas pipelines are almost perfect natural monopolies.

1.2 The problems with cost-based pricing in the wholesale gas market

Applying cost-based pricing as the central element in a reasonable pricing provision raises several difficult questions:

- The code will apparently include all domestic supply to the east coast, including Narrabri, new Bass Strait developments or similar offshore developments, new coal seam gas fields, and Northern Territory gas (such as Beetaloo) supplied to the east coast. Will it apply to gas supplied to the east coast via import terminals regardless of source? If so, how will the cost base be established for such a supplier?
- Exploration is a high-risk activity in which the costs of failures are balanced by successes and reflected in market prices. What principles will be used to determine the costs of 'efficient new developments' within the reasonable-pricing provision?
- How will asset depreciation be calculated based on economic life when climate policy will surely limit the economic life of the assets?
- Will there be a published single reasonable price, nodal price (eg Wallumbillah Hub) or, as implied, will every arbitration require its specific determination of a reasonable price? Will agreed principles be published so that producers and purchasers can negotiate based on expectations of arbitration?
- Is it expected that the producer and consumer will negotiate with reference to a reasonable price, but will that price be pre-determined or determined only after arbitration has been called for?
- Under current circumstances, any price cap or reasonable pricing provision would deliver a price, be it $12 or $20 per gigajoule,

well below today's LNG export parity netback price, but above that which applied less than two years ago. A return to pre-war global prices may seem optimistic. However, the LNG netback price could well fall below the determination of the indicative reasonable pricing provision. The producers would have a case for arbitration to support the cost-based reasonable pricing provision and purchasers would argue the case that they should not pay more than overseas buyers. How might this issue be addressed within the code's provision?

2 Consultation questions

Outside the reasonable-pricing provision, the obligations outlined in the code appear reasonable and there is no obvious reason that they should not transfer to a mandatory code. Assuming the Australian Domestic Gas Security Mechanism ADGSM and renegotiated Heads of Agreement remain in place, the threat of arbitration, available to both suppliers and purchasers, is intended to replace the power-balancing influence of the market, on the premise that the market was non-competitive even before the Ukraine war. That premise is arguable, but if it is accepted, the methodology on which a reasonable price is calculated will determine whether the bargaining power is balanced.

The consultation seems to treat gas producers and wholesale gas suppliers as being the same. As the market seeks solutions to the potential east-coast gas shortfalls identified by the ACCC and the Australian Energy Market Operator (AEMO), it is at least possible that suppliers who deliver gas via import terminals are traders or retailers rather than producers. It would seem problematic to exclude them from the code of conduct, but their inclusion adds a further dimension to the complexity of cost-based pricing.

For the reasonable-pricing provision to act as a clear basis for price negotiation without being a version of economic regulation, the basis for an arbitrator's decision must be clear before the fact, and the detailed principles on which the efficient long-run marginal cost will be calculated should be worked through and agreed alongside the introduction of the code. As described earlier in this submission, applying cost-based pricing assessment to the wholesale gas market has several challenges that are likely to be highly contested, because there is little if any precedent for this type of assessment of reasonable prices.

Intervention in the east-coast wholesale gas market has been necessary. Some of the risks of intervention are already evident in the application of the simpler of the interventions, the price cap. Unless the issues raised in this submission are addressed, the risks of major disruption to supply could crystalise in ways difficult to foresee because they are unprecedented.