AUSTRALIAN ENERGY COUNCIL

Gas Market Consultation
Labour Market, Environment, Industry and Infrastructure Division
The Treasury
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Submitted via email: GasMarketConsultation@treasury.gov.au

7 February 2023

RE: Options to ensure the domestic wholesale gas market delivers for Australians

The Australian Energy Council (AEC) welcomes the opportunity to make a submission in relation to the proposed mandatory code of conduct ('the Proposed Code') as discussed in the Government's consultation paper 'Options to ensure the domestic wholesale gas market delivers for Australians'.

The AEC is the peak industry body for electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. AEC members generate and sell energy to over 10 million homes and businesses and are major investors in renewable energy generation. The AEC supports reaching net-zero by 2050 as well as a 55 per cent emissions reduction target by 2035 and is committed to delivering the energy transition for the benefit of consumers.

In the AEC's view, given the dynamic and complex nature of energy systems, any mandatory rules (be they via industry codes of conduct or otherwise) should be implemented with caution, precision, and regular monitoring to minimise risks of unintended consequences.

The AEC provides this submission as a supplement to (and to be read in conjunction with) the AEC's prior response dated 15 December 2022. Specifically, this submission appends the AEC's views on why extending the Proposed Code to capture retailer contract offers would be inappropriate.

The AEC contends that the Proposed Code should not be expanded to include retailer contract offers, as:

(i) **it would be a regulatory over-reach**: retailer contracts are not the driving force behind high gas prices, therefore including retailers would be beyond the Proposed Code's issue-solving objectives (and contrary to Commonwealth policy), and

(ii) **retailers' role in the supply-chain is different (they take on demand-side risks), so the Proposed Code is inappropriate:** The Proposed Code is designed for gas producer supply arrangements. Retailers' role in the supply-chain involves a different risk profile, cost structure and interplay with customers – a context the Proposed Code is not tailored for.

(i) Including retailer contract offers in the Proposed Code would be a regulatory over-reach

Industry Code of Conduct Policy Framework requires narrow and clear scope

Under Commonwealth policy, industry codes of conduct should be narrowly tailored to address specific and clearly defined issues in the sector.

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The AEC notes the *Industry Codes of Conduct Policy Framework 2017*[1] ('The Policy Framework') where the Commonwealth sets out preconditions and criteria for industry codes of conduct and emphasises their minimal and cautionary application. The Policy Framework states:

> "While codes offer a flexible regulatory tool to address market concerns, it is important to remember that codes do come at a cost to business. Codes are only prescribed by the Government in very limited circumstances where there is a compelling case for intervention, supported by robust evidence."[2]

The AEC also notes The Policy Framework's prescriptive terms regarding threshold criteria for Code creation and design:

> "Before the Government undertakes any formal detailed analysis of the proposed code developed by Industry, it ***must*** first be satisfied that certain threshold criteria have been met".[3]

Moreover, in The Policy Framework's criteria titled "Identifiable Problem in the Industry", the Commonwealth confirms the importance of a narrowly scoped code focussed on solving clearly articulated issues. It expounds:

> "***the nature and magnitude of the problem should be identified with precision, to ensure that any regulatory response can be adequately targeted.***[4]***"***

Therefore, in the AEC's view any assessment of scope pertaining to the Proposed Code must be grounded in answers to the critical questions:

- what ***precisely is the problem*** in the gas supply chain? and,
- ***precisely which participants and transaction types*** are producing that issue?

While the ultimate challenge is the high cost of gas for end consumers, the objectives set out in the consultation paper[5] make it clear that the key underpinning issue is the ***cost of gas supply*** - considered to be unreasonably high relative to the long-run costs of production.

In the section below the AEC sets out why the retailer contracts are not driving these high prices.

High gas prices are driven by domestic producers' access to constrained international markets

International factors, punctuated by the Ukraine conflict have converged to push international prices to record highs. Australia's east coast LNG export capabilities connect Australia's LNG producers to this international supply-hungry market providing them with a depth of alternative trading options ultimately yielding market power and a strong influence on domestic price offers.[6]

[1] The Australian Government – The Treasury, '*The Industry Codes of Conduct Policy Framework 2017*', https://treasury.gov.au/sites/default/files/2019-03/p2017-t184652-5.pdf

[2] The Australian Government – The Treasury, (n1), p1

[3] The Australian Government – The Treasury, (n1), p11

[4] Ibid

[5] The Australian Government – Department of Climate Change, Energy, the Environment and Water, '*Options to ensure the domestic wholesale gas market delivers for Australians – Consultation paper, December 2022'*, p7

[6] ACCC, '*Gas inquiry 2017-2030 – Interim report, January 2023' (hereafter referred to as ACCC Report)*, p14, https://www.accc.gov.au/publications/serial-publications/gas-inquiry-2017-2030/gas-inquiry-january-2023-interim-report

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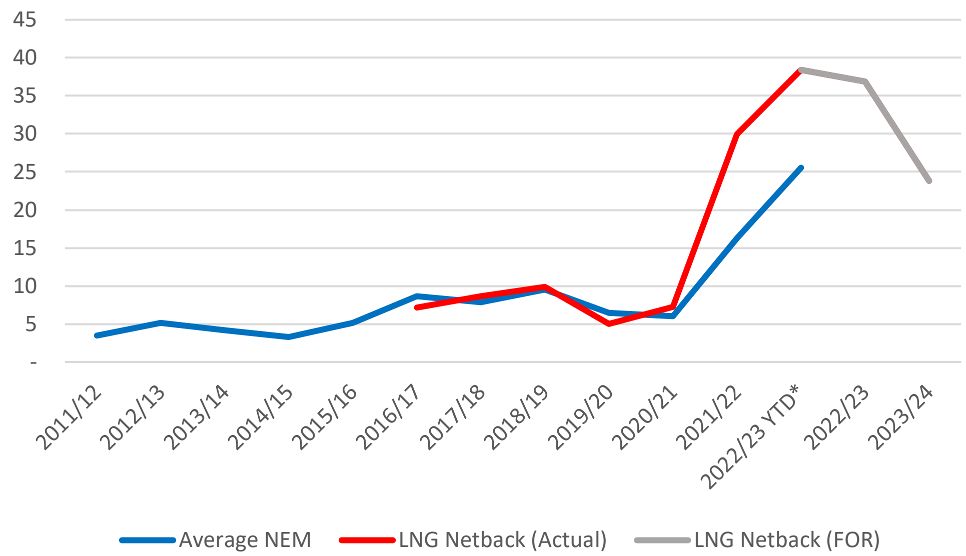
Through formal or informal pricing processes, producers use the 'export parity netback price' as a reference for domestic contract pricing rather than (or at least alongside) the underlying long-run cost of production. This international - domestic price linkage is clear and has been documented by numerous bodies including the RBA[7] and most recently the ACCC.[8]

Figure 1 below shows the aligned trends between domestic and international (netback) gas prices.

*Figure 1. Financial year average NEM wholesale gas prices to August 2022, historical actual LNG netback prices to August 2022 and futures, as at 30 January 2023 (AUD/GJ). *'YTD' is August financial year to date.*



Source: https://www.accc.gov.au/regulated-infrastructure/energy/gas-inquiry-2017-30/lng-netback-price-series
https://www.aer.gov.au/wholesale-markets/wholesale-statistics/gas-market-prices

Retailer participation in the wholesale market is not the cause of the high price of gas supply
In contrast to most gas producers, wholesale buyers are restricted to transact with domestic counterparties – a shallower pool of options and thus are natural 'price-takers'. In their recent report *Gas inquiry 2017-2030 – Interim report, January 2023* ('the ACCC Report'), the ACCC highlighted that retailers are amongst the constrained buyers impacted by producers, when they mention that, according to some users "retailers were unable to supply gas due to their inability to obtain gas from producers."[9]

That said, retail market participants also at times, offer wholesale contracts to either close out a long position or pass on supply arrangements to large commercial and industrial consumers. In such transactions retailers do not hold bargaining power commensurate to their gas producer counterparts as retailer alternative price options are limited to (a) comparable domestic wholesale deals - in which case retailers may be 'price-followers', (with producers setting market price), and (b) retail market sales - where, being competitive and geographically constrained retailers are incentivised to offer customers acceptable prices.

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[7] de Atholia & Walker, *'Understanding the East Coast Gas Market'*, The Reserve Bank of Australia, Mar 2021. https://www.rba.gov.au/publications/bulletin/2021/mar/understanding-the-east-coast-gas-market.html
[8] ACCC Report, p14.
[9] ACCC Report, p60.

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Such contract offer pricing from retailers is evidenced in the ACCC Report, where, during the recent peak price period retailer offers are shown to have been predominantly below producer offers.[10]

Therefore, while retailers are often price-followers in the wholesale market, they operate in a competitive geographically environment and their participation in the wholesale market (as seller or buyers) is not driving the east coast high gas supply prices.

Given the strong guidance set out in The Policy Framework regarding narrowly and precisely designed scope, and the evidence that retailers' participation in the market is not causing the high domestic prices, in the AEC's view, the Proposed Code should not be expanded to include retailer contract offers.

(ii) Retailers' role in the supply-chain is different (they take on demand-side risks), so the Proposed Code is inappropriate

Downstream from gas production and converging with wholesale trading, retailers' role in the supply chain is to manage wholesale market risks and requirements for their customers. This is a net buy-side exposure involving price volatility and regulatory risks, and market operational and prudential requirements. Retailers also provide customers with support services and adapted products while undertaking customer billing (for full supply-chain costs) and managing the resultant customer debtors book.[11]

Beyond the lack of nexus between retailers and the underpinning issue, in the AEC's view the Proposed Code, is wholly inappropriate to apply to retailers as it does not consider the retailer context, natural incentives or bargaining power - given their role in the supply-chain.

The context for retail supply contracts is even further removed from the Proposed Code's design and the AEC assumes that in no scenario would it be envisaged to expand the Proposed Code to cover such arrangements. The NECF mechanisms in place provide sufficient regulatory oversight of retailer interactions with small customers and in the AEC's view no further intervention is warranted.

Any questions about this submission should be addressed to Jane Sing, by email to jane.sing@energycouncil.com.au or by telephone on (03) 9205 3100.

Yours sincerely,

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[10] ACCC Report, p14, Chart O.3.

[11] *Certain retailers also take on retailer of last resort (ROLR) responsibilities - which is an increasingly risky proposition in the current market.*