

15th July 2015

Mr Rod Sims
Chairman
Australian Competition and Consumer Commission
GPO Box 520 Melbourne Vic 3001

Dear Mr Sims

Re: East coast gas market review

Manufacturing Australia (MA) is an alliance led by the CEOs of some of Australia's largest manufacturing companies (Allied Mills, Bluescope, Brickworks, Capral, Cement Australia, CSR, Incitec Pivot Limited, Orora, Rheem¹) whose goal is to prosecute a range of policy issues to help ensure a strong and vibrant future for the sector.

Our members have billions of dollars invested in manufacturing facilities across Australia. They operate hundreds of plants across the country, which provide ongoing employment to thousands of people, including a highly skilled workforce. Most of these facilities rely on gas, either as a major energy source or as an input to supply. It is critical that Australia's gas is supplied out of a transparent, competitive and liquid gas market if manufacturing in Australia is to remain globally competitive.

Many MA members have commercial arrangements with various gas producers and/or retailers and some of these have outlined, where required, the details of these arrangements as part of the ACCC's investigations into the east coast gas market. As an industry body, MA's response to this inquiry is largely based on information provided by members who are heavy users of gas and often require gas as a feedstock. However, the functioning of the east coast gas market has wider implications for all downstream users of gas (wholesale and domestic).

Manufacturing Australia's primary concern is the inability of industrial gas users to secure long-term gas contracts at competitive prices with reasonable terms and conditions. Just six parties currently control around 90% of our vast east coast gas reserves² and these parties are now largely focused on meeting the demands of the LNG export markets.

To secure the interests of domestic industrial gas users and restore proper market function, regulatory intervention is required. Reforms should create a market structure in which domestic customers have a genuine opportunity to compete and bid for available gas. Such a structure would also mean suppliers are more likely to:

- allocate a portion of their gas to domestic customers;
- divest a portion of the gas portfolio to third parties to develop and supply to domestic market; or,

¹ Our member CEOs are: Josph Di Leo (Allied Mills); Paul O'Malley (Bluescope); Lindsay Partridge (Brickworks); Tony Dragicevich (Capral); Rob Davies (Cement Australia); Rob Sindel (CSR); James Fazzino (Incitec Pivot); Nigel Garrard (Orora); Matt Sexton (Rheem).

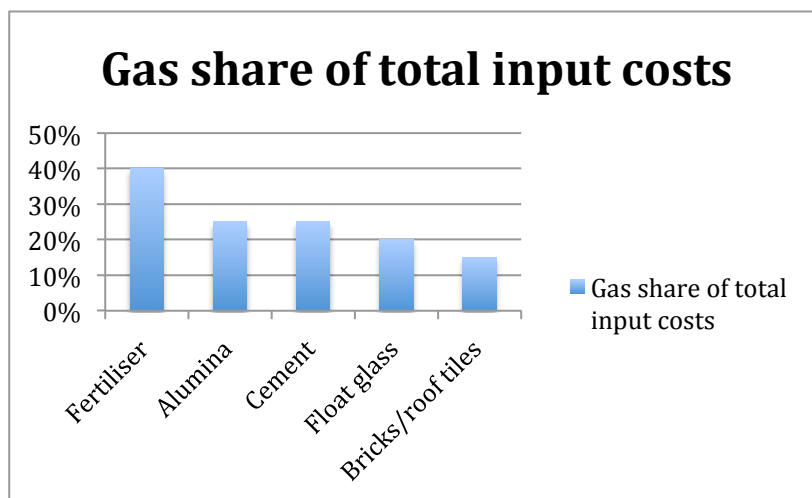
² Where each LNG Joint Venture (JV) is one party, and the Gippsland Basin JV is one party.

- provide access to infrastructure to third parties supplying gas to the domestic market.

The importance of competitively priced gas in manufacturing

Since 2011, MA has been warning governments, both federal and state, of the impending crisis facing local manufacturers. Improved competition and transparency is urgently required if we are to tackle the substantial uncertainty and insecurity in domestic gas supply that is hindering the ability of manufacturers to secure long-term contracts upon which their operations rely.

Natural gas makes up to 15-40% of the cost base of fertiliser, alumina, cement, float glass, brick and roof tile production. Gas is used as feedstock in plastics and chemicals (currently Australia’s second largest manufacturing sector) and in fertilisers and explosives (which support Australia’s two primary export industries agriculture and resources). It is also a favoured energy input in other manufacturing, especially alumina, bricks, cement, float glass, steel, glass container manufacturing, paper and roof tile production.³ Where gas is used as a feedstock, switching fuels – such as to coal – is not an option. And in other cases, the costs involved in changing fuels, in terms of plant upgrades or retrofits, often make the option prohibitive.



Therefore, gas must be readily available and competitively priced if we are to prevent the prospect of demand destruction within Australian industry, such as that which occurred in the USA in the 1980s. Skyrocketing energy prices at the time saw much of America’s manufacturing shut down and sent offshore, leaving a lasting impact on the fabric of that country. Today, the USA is seeing industrial energy demand return – along with jobs and economic prosperity – on the back of deliberate government energy policies that have driven energy costs down and capitalised on the shale gas boom.

The impacts of the LNG boom

³ Manufacturing Australia (MA), *Impact of gas shortage on Australian manufacturing* (May 2013) p.3

Price rises

The emergence of Australia's export-focused LNG market, at unprecedented scale, has already seen gas prices double or triple previously contracted prices - from \$3-4 per gigajoule to the current gas price up to \$10/GJ, or even more depending on location. The rapid expansion of the sector has also included dramatic consolidation within the domestic gas market. As a result of these events, many gas-intensive manufacturers have had difficulty renewing or establishing gas supply contracts. A lack of market power by domestic users has led to the withholding of offers from suppliers; "take or pay" contracts; minimal negotiating parameters; and little transparency of pricing.

With its significant gas usage and high trade exposure, the manufacturing sector is projected to decline by up to \$120 billion by 2021⁴ unless this issue is addressed urgently, with projections also suggesting between 13,000⁵ – 83,000⁶ direct manufacturing jobs are at risk. The situation is already contributing to plant closures and redirected investments from existing manufacturing business, and also lost opportunities for new investment. For example, Incitec Pivot Limited has revealed gas costs at its Phosphate Hill fertiliser plant in Queensland will increase by \$50 million a year in 2016. The rising cost of gas was also a key factor in the company's decision to build a US\$850 million ammonia plant in Louisiana rather than in Australia.

Lack of supply for domestic industrial users

The challenge of securing supply is so great, several manufacturers have been forced to make investments in gas production that are outside of their core business. MA members Orora and Brickworks have both entered into gas supply agreements with Strike Energy to supply gas from prospective CSG fields in the Southern Cooper Basin to their manufacturing facilities, from 2018. Incitec Pivot Limited has also signed similar agreements with Central Petroleum (NT) and Real Energy (Cooper Basin). The significant investment and risk required to enter into these arrangements is not something many companies would have previously considered and is indicative of market dysfunction in relation to domestic supply.

There is significant risk of gas shortfall on the east coast. Recent analysis by EnergyQuest predicts a 133PJ gas shortfall along Australia's east coast in 2019 and a significant short-term supply gap, which increases to over 200 PJ per annum early next decade⁷. This shortfall could force some factories to close during high demand periods and puts upwards pressure on prices.

It also impacts profit margins. Just this month, Incited Pivot Limited (IPL) advised the ASX of a gas supply reduction to its ammonium nitrate plant at Moranbah in central Queensland. IPL's Moranbah plant is supplied pursuant to a gas supply agreement with

⁴ Deloitte Access Economics *Gas market transformations – Economic consequences for the manufacturing sector* (July 2014) p.3

⁵ Full time equivalent jobs lost to 2021, *ibid* p.3

⁶ Manufacturing Australia (MA), *Impact of gas shortage on Australian manufacturing* (May 2013) p.3

⁷ http://www.energyquest.com.au/uploads/docs/aemo_gsoo_20150526_final.pdf

the Moranbah Gas Project joint venture, operated by Arrow. Arrow advised that the supply reduction will extend into 2016 and be in the order of 10-20%. While noting the uncertainty as to the extent of the supply reduction and its impacts, if there was to be a sustained and consistent 20% reduction in gas supply over a 12 month period, IPL estimates that the impact on the Group's Net Profit After Tax (NPAT) would be in the order of A\$22 million. The impact on IPL's NPAT for the 2015 financial year is potentially up to A\$6 million⁸.

Despite the potential for domestic supply constraints, producers appear to have little incentive to develop certain reserves – and there is no legal imperative to do so. For example, Shell has not proceeded with investment in an LNG facility at Gladstone and is currently sitting on substantial gas reserves through the Arrow joint venture. Shell's former chief executive Peter Voser confirmed in 2012 that Australia's regulatory framework allowed projects to be put on hold without loss of development rights: "Australia obviously has some advantages because you may actually delay (a project), which maybe you cannot do in other countries because we have permits expiring, etc," he said⁹. Despite the impending shortfall, there is no evidence or indication Shell will unlock any of these reserves for domestic customers without a regulatory imperative.

MA believes that, without improved price transparency, "use or lose it" requirements, or a market that provides genuine opportunity for domestic customers to bid and compete, LNG producers do not have an incentive to supply to domestic consumers. Any financial incentive currently favours efficient transportation through established pipelines developed at scale for export. This financial incentive could potentially be increased should the proposed acquisition of BG by Royal Dutch Shell be approved, due to the potential for shared infrastructure. Producers will also wait for more favourable netback export pricing, rather than sell to domestic users. For example, Origin Energy managing director Grant King said at a recent annual shareholders meeting that the company would "reduce its call on production from its upstream business and bank contracted gas this year and call for that gas in the following years when it is more valuable."¹⁰

BG Group's representative to AEMO's Moomba Gas Hub Reference Group is also on record saying the development of such a hub would be of no benefit, despite it being of benefit to other market participants. It suggests BG has little interest in accommodating the domestic market.

Lack of access to pipelines

Regulatory hurdles, capital constraints, and technical skills all constitute significant barriers for small gas explorers to become suppliers. Access to pipeline capacity is also a major barrier. International best practice for governance of pipeline infrastructure varies between the UK, Europe, and the USA, but the common themes are recognising the monopoly nature of pipelines, the need for a segmented value chain (both in legal and contractual ownership terms), and open and transparent tradability of capacity.

Furthermore, junior gas suppliers have had difficulty accessing processing facilities. This

⁸ Moranbah Update, 8th July 2015, <http://investors.incitecpivot.com.au/phoenix.zhtml?c=170340&p=irol-news>

⁹ 'Shell flags gas project delays because of cost pressures' by Matt Chambers, *The Australian*, July 28, 2012

¹⁰ Sydney Morning Herald, July 6, 2015 "Gas producers accused of profiteering, hoarding"

was identified in the Parer Report¹¹ which recommended that the industry principles for third party access regimes be reviewed. The report viewed access to third party processing as hindering market development. Generally, new producers who wish to reach wholesale markets have been required to buy into or develop their own capital, as access conditions have been too onerous.

The small number of companies who currently control the market already appear to have used this market dominance to restrict supply, manipulate the domestic price and establish onerous and opaque terms and conditions. For example, a Credit Suisse analyst report from March 2014 highlights some of the strategies employed by producers to manipulate prices: “Santos now argues that its aim in GLNG was always as much about raising the domestic gas price, and therefore re-rating the portfolio outside of GLNG, as it was about the project¹².”

Conclusion

Without a transparent and competitive east coast gas market, we run the risk that domestic customers pay even more than the so-called international price, and yet will have little opportunity for comparison or recourse other than to cease operations and move offshore. If gas-intensive manufacturing leaves Australia it is not likely to return – even if prices revert to sustainable levels – because of high costs of construction, loss of skills and supporting supply chains, and higher risk premiums.

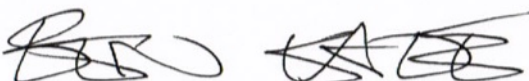
Australian governments and regulators must decide if they want to achieve a “best of both worlds” outcome: where a thriving gas exports sector operates alongside domestic industry that adds value to these materials and in turn, supports additional local jobs other than those generated by its extraction.

If sensible reforms to restore balance to the gas market can't be achieved in the next 12-18 months, governments (both state and federal) are likely to face mounting calls for emergency gas reservation, or face widespread offshoring of gas-intensive manufacturing.

Diversity of suppliers, along with appropriate infrastructure and competitive, transparent, trading markets, is critical.

Please do not hesitate to contact me should you wish to discuss further.

Yours sincerely,



Ben Eade
Executive Director
Manufacturing Australia

¹¹ Council of Australian Governments Energy Market Review *Towards a Truly National and Efficient Energy Market* (2002) p. 222

¹² Credit Suisse analyst report, 'Has GLNG been a good investment?' (March 2014)