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Australian Domestic Gas Outlook 2019
Four Seasons Hotel Sydney,

9.30-10am - 5 March 2019,

Keynote speech by:

The Hon Martin Ferguson AM
Chairman, APPEA Advisory Board

Theme: "*POST-NEG POLITICS AND IMPLICATIONS FOR GAS MARKET POLICIES*"

In the backdrop of the National Energy Guarantee and political aftermath following its demise, hear thoughts from one of the leading political figures of the past two decades on what level of federal interventionism is practical, appropriate and legal for the government to undertake in addressing long-term issues that plague the gas market.

- CHECK AGAINST DELIVERY -

Introduction

Protocol: Distinguished guests, ladies and gentlemen,

It is a pleasure to deliver this keynote address.

The Australian Domestic Gas Outlook conference is in its seventh year and has become a fixture in the calendar for everyone involved in the local gas market.

That is, of course, a tribute to the organisers and the speakers who have made this conference an event.

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I would also say that the interest in this conference reflects how turbulent the last seven years have been – for customers, producers, retailers.

Over the last seven years, we have seen historic shifts in the market – especially on the east coast.

We have seen $200 billion in investment deliver a new generation of projects to supply export and local customers.

These projects are expected to produce $50 billion in exports this financial year as well as supplying the domestic market.

For the first time - on the east coast - we are seeing gas exported as liquified natural gas.

The upstream industry on the east coast is now larger and more diverse than a decade ago – production has tripled in just five years.

The traditional basins which have supplied eastern Australia for almost fifty years now produce less gas at higher cost.

A new, unproven resource – coal seam gas – has been developed into the main source of supply on the east coast.

While important new projects are underway in offshore basins and onshore, coal seam gas now accounts for about 75 per cent of production and almost 90 per cent of reserves.

Investment on an unprecedented scale was required to turn the potential of coal seam gas into actual supply.

The opportunity of converting coal seam gas into LNG exports made the business case for this investment.

Without the LNG opportunity, local customers would have had to fund, entirely, the creation of new supply.

I can remember that the preferred option for Queensland before CSG was constructing a pipeline from New Guinea – hardly a cheap, risk-free option.

It is not only the geology of the upstream industry that is changing. So is the geography.

The new coal seam gas resources are located in Queensland, far away from the main demand centres of the east coast.

As more and more Queensland gas is shipped south, major changes to pipeline flows and infrastructure will follow.

Capacity constraints loom on key infrastructure such as the South West Queensland pipeline.

The switch in supply from south to north to increasingly north to south adds costs – the Australian Competition and Consumer Commission estimates that shipping Queensland gas to Melbourne adds $2 to $4 a gigajoule.

Even more importantly, the costs of producing coal seam gas are significantly higher than traditional conventional sources of supply.

This point is clear in the Core Energy and Resources' report released just before Christmas by the Australian Competition and Consumer Commission.

That report estimates break-even costs for gas production from twenty-three regions, showing a widening cost gap between legacy projects in established basins and new, largely unconventional gas projects.

Unfortunately, the report also shows that nearly all of the 2P reserves on the east coast are to be found in the higher cost basins, namely the Surat, Bowen and Gippsland.

As all these numbers indicate, the implications of the rapid shift to reliance on coal seam gas from Queensland are significant.

The public and political debate has not really grasped that point.

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The emergence of an export-focused gas industry has delivered huge economic benefits – regional development, infrastructure and jobs (especially in Queensland) and a massive boost to Australia's terms of trade.

However, for some local customers, the new LNG industry is seen as a disruptive threat to their businesses.

That is natural. The east coast market is less of a buyer's market than it once was.

In particular, many people blame linking the local gas market to the regional LNG market for the rise in east coast gas prices over the last five years.

Until recently, the people making this argument often claimed that east coast gas prices are far higher than gas prices in countries such as Japan which import our LNG.

With the wealth of data now being produced by the ACCC and other independent sources, it is clear that the prices paid by east coast customers are lower – not higher - than comparable prices in Japan, Korea and China.

As the ACCC's fortnightly reporting shows, local prices are typically below LNG netback levels.

This gap is, incidentally, one of the hurdles for proponents of LNG import terminals.

Import terminals are one way to expand supply in southern markets – in my view, a second-best option because Australia exports jobs and royalties by not developing our own resources.

It is an option only under consideration because of the political barriers to local projects in the southern states.

In terms of public policy, it is a spectacular own goal by governments which desperately need more gas but refuse to support local projects.

The import terminal option requires a positive opportunity for arbitrage.

12 months ago, some buyers seemed confident that this opportunity existed – after all, the newspapers were full of stories about Australian prices being higher than landed prices in regional countries.

Now there seems to be an emerging consensus that imported LNG is more likely to set a ceiling on local prices than create a new floor.

This analysis doesn't mean that import terminals should not proceed but it does inject some realism into the price expectations of prospective customers.

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So, to sum up this broad picture:

- The east coast gas market has changed fundamentally;
- Ten years ago, the market faced a near-term challenge in replacing supply from dwindling conventional sources in the Cooper and offshore Victoria;
- While industry investment has restored output from the traditional basins, the real expansion has occurred in Queensland with coal seam gas;
- The emergence of LNG exports has changed market dynamics by creating massive new supply AND linking the east coast to the regional LNG market;
- The resource developed for export – coal seam gas – is increasingly a major source of supply to the domestic market;
- Prices have risen sharply, due mostly to the shift to higher cost sources – both higher cost conventional gas projects and coal seam gas; and
- We are seeing a growing mismatch between where our gas is produced and where it is consumed.

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I have been asked to put this market story into a 'post-NEG' context.

I’m not sure if we are living in a ‘post-NEG’ period – if Labor is elected in May, we may think of this time as ‘pre-NEG’, given Labor seems likely to reintroduce the NEG.

But I take the point that all pretence of bipartisan energy policy has well and truly disappeared in the last few months.

And it seems likely that the political infighting over climate change and energy policy will intensify over the next term of government.

Hardly a positive situation for anyone in business who faces critical commercial decisions.

So

- What should be done to promote the development of new resources, especially in the southern markets which face ever tightening supply ?
- What should be done to support businesses under pressure from higher energy prices – it is not just gas prices which have increased ?
- What should be done to bolster confidence in the market ?

I spent some time outlining what I believe are the key drivers affecting supply and prices in the east coast market because policy has to tackle the real sources of the problem.

You may have guessed by now that I don’t see LNG exports as the sole or main cause of higher gas prices on the east coast.

So I don’t see that there is any genuine or lasting solution in stifling investment in the LNG industry which is, after all, a major supplier of gas to the domestic market.

I would also point out that many businesses are adapting to the new market conditions. We will hear from some of these businesses during this conference.

These businesses have accepted that energy costs are a major business risk which demands new strategies.

These businesses are now:

- investing in upstream projects;
- using collective purchasing agreements;
- trading in short-term markets; and
- using energy efficiency to limit their exposure.

This shift in thinking and business strategy will continue, regardless of the policy choices made by governments.

For their part, governments will have to put aside the short-term populist politics of the moment to do some genuine hard work.

Leadership will be required. And not just from the Commonwealth which has relatively few direct levers.

The starting point for reform has to be that lower prices cannot be achieved, on a sustainable basis, unless costs are lowered.

This fact has been partly recognised by energy Ministers who have sponsored significant reforms to some parts of the industry supply chain.

Most of these changes have focused on promoting competition through greater transparency.

As such, these changes can be seen as continuing the evolution of the market – part of a long sequence of reforms beginning with the launch of the Gas Market Bulletin Board in 2008.

These initiatives have helped to bolster confidence in the market.

More transparency facilitates greater competition.

The COAG Energy Council has rightly supported the public provision of key data such as prices and volumes.

In their pre-Christmas report, the ACCC and the Gas Market Reform Group has recommended further changes which will make the market much more transparent.

Some of these proposed changes seem to me of marginal value for commercial decision-making, for example the suggestion that there be a single benchmark set for producers reporting their reserves.

Nevertheless, the general direction is sound.

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However, as much as more transparency and more competition helps, the market needs, most of all, <u>more supply and more suppliers.</u>

In practice, this means better access to resources and regulatory reform to lower exploration and production costs.

In the first case, the crippling constraint on alleviating price pressures on customers in New South Wales and Victoria is state bans and moratoria.

We are all familiar with the absurd situation that the states with the greatest need for gas are also the states which have killed local onshore development.

New South Wales and Victoria have chosen to abdicate their responsibilities – they offer no solution to the mounting pressures on customers in their states.

Both governments prefer to out-source their states' gas needs to other states.

The Victorian government even appears to be reluctant to support an LNG import terminal.

This stance may have short-term political benefits but it risks a much greater problem in the next two to three years.

There is mounting evidence that, from 2021, Victoria could face a supply shortfall during periods of peak demand in winter.

We have seen where this political approach from our two largest states leads.

In 2017, facing concerns about a <u>possible</u> shortfall in the domestic market, the Commonwealth intervened using the biggest stick they have – export controls.

The Australian Domestic Gas Security Mechanism was introduced as a short-term measure with a sunset clause of 2023.

The threat of restricting LNG exports was intended to force LNG projects to divert more gas into the east coast market.

While the Commonwealth announced modest grants to accelerate delivery of gas from some relatively small projects, the thrust of policy was to redistribute existing production, not stimulate more production, let alone stimulate

production in the southern markets where the risk of a shortfall lay.

The LNG industry response was to guarantee that uncontracted gas would be offered to the domestic market first.

I see this commitment as important in boosting confidence in the market. The anticipated shortfall in 2017 has not eventuated, thanks in part to the flow of new gas from non-LNG projects.

The past year has seen major announcements from Arrow Energy, Shell Australia, Senex, Cooper Energy, Strike Energy, GLNG, Australia Pacific LNG, Origin Energy, Santos, ExxonMobil and BHP delivering new gas supply.

The latest ACCC gas market report confirms east coast gas prices remain below 2017 peaks, due largely to this new supply entering the market.

This is not to gloss over the fact that, for some businesses, price offers in the range of $8-$12/GJ are challenging.

However, as I have stressed, using Queensland gas to supply southern markets does not deliver lower prices.

The solution to tightening market conditions in New South Wales and Victoria is more local supply, not interventions which put at risk investment in developing Queensland gas reserves.

Unfortunately, the federal opposition has doubled down on export controls, announcing that it intends to make the ADGSM permanent and to effectively use export controls to set price caps in the market.

This is a dangerous path for a country which relies on continuing international investment to develop its resources – it would be especially dangerous if it led to contracts being overturned.

In 2017, the ADGSM sent a disturbing signal to investors. De facto price regulation underpinned by export controls would be even more concerning.

Many people are likely to welcome this approach. Customers will like the idea of lower prices and may not be very concerned about how this is achieved.

However, as business people, we appreciate that policies designed to depress prices invariably discourage investment and eventually fail.

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The stakes for Australia could hardly be higher – a least-cost transition to cleaner energy and energy security for local industry or continuing with inconsistent policies that destroy jobs, push up prices and perpetuate higher emissions.

I have focused on the barriers to developing new supply and the lack of action from governments to reduce regulatory costs.

It is these interventions which are stifling supply and inflating costs – not the growth of a strong export industry on the east coast.

The Commonwealth has limited direct levers but it must find ways to work with all states to tackle the root problem - flat or declining supply in the southern markets.

More transparency and competition in the market are vital for efficiency and public confidence.

Better access to develop local, onshore gas projects is essential.

A concerted COAG effort to ensure we have 'fit-for-purpose' regulatory regimes which satisfy community expectations without excessive, unnecessary costs is equally essential.

If we don't take these steps, our transition to a cleaner energy sector and our energy security will be challenged.

Our manufacturers and households will continue to feel the pressure of higher energy costs.

We will fail to take full advantage of the economic and social opportunities created by the investment in our LNG export industry.

This investment can be leveraged to deliver benefits to all Australians – including more efficient and secure domestic energy supply.

It should be an exciting future – if we can find a way to make the right long-term decisions.

Thank you.

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