Major Energy Users Inc.

12 April 2021

Australian Competition and Consumer Commission
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By email: LNGnetbackreview@accc.gov.au

ACCC LNG net back price series review
Response to the ACCC Issues Paper March 2021

The Major Energy Users (MEU) is pleased to respond to the ACCC gas netback price review process and its Issues Paper dated 18 March 2021.

About the MEU

The MEU was established by very large energy using firms to represent their interests in the energy markets. With regard to all of the energy supplies they need to continue their operations and so supply to their customers, MEU members are vitally interested in four key aspects – the cost of the energy supplies, the reliability of delivery for those supplies, the quality of the delivered supplies and the long-term security for the continuation of those supplies.

Many of the MEU members, being regionally based, are heavily dependent on local staff, suppliers of hardware and services, and have an obligation to represent the views of these local suppliers. With this in mind, the members of the MEU require their views to not only represent the views of large energy users, but also those interests of smaller power and gas users, and even at the residences used by their workforces that live in the regions where the members operate.

It is on this basis the MEU and its regional affiliates have been advocating in the interests of energy consumers for over 20 years and it has a high recognition as providing informed comment on energy issues from a consumer viewpoint with various regulators (ACCC, AEMO, AEMC, AER and regional regulators) and with governments.

The MEU points to the reality that gas prices in the east coast domestic market are too high, especially for a nation that is currently the largest exporter of LNG in the world – the ACCC has highlighted this in its regular interim reports on the east coast gas market. Further, the ACCC also highlights that consistently the domestic price for gas exceeds the netback price for gas it calculates, effectively recognising that the netback price is to be a “floor” price for the domestic market by gas producers and the LNG exporters. While the MEU accepts that the netback price is only an indicator for the domestic east coast gas market, gas consumers have not seen many prices for gas that anywhere approach the netback price, and where they do, contract durations are very short.

It is with these thoughts in mind, that the MEU makes to following comments.

The intention of the netback price

The intention of the net back price is to set a domestic value for natural gas at Wallumbilla where the exporters would be indifferent to buying gas at Wallumbilla for either selling in the domestic market or to export, using the current Asia spot market price as a point of reference.

Rather than achieving this, what the ACCC has determined in its net back price is one effectively where the exporter is indifferent **at the point of loading its LNG** whether the gas is exported or sold back into the domestic market. The MEU considers that to generate a gas market where there is balance between buyers and sellers, uncontrolled by the dominance of the major producers, costs that are not incurred by the LNG exporters when the gas is sold domestically should be excluded from the netback price.

Essentially, the ACCC has developed a netback price that reflects a bias in favour of the seller rather than that of the buyer. By doing this, the ACCC has embedded in the seller’s price, costs that it never incurs when it sells the gas domestically, thereby inflating the margin on the domestic sale.

The netback price as developed does not reflect the real costs involved in producing the gas to be used domestically. For example, there are other producers in the Surat and Bowen CSG fields who supply only to the domestic market, yet their selling prices are being set with reference the netback price developed by the ACCC based on what the LNG exporters have advised the ACCC what their costs are and what domestic gas price is needed to recover these costs. This approach means that effectively, if the gas providers for the domestic market can include in their pricing not only the costs of extraction of gas (much as the LNG exporters incur) but also the cost of transport to Gladstone and processing LNG, that is, the producers for the domestic market can include costs in their selling price the equivalent cost of processing LNG (some $3-4/GJ) as a profit margin – costs they do not incur.

Establishing the inputs for the netback price

The MEU does not consider that the ACCC has implemented an appropriate price approach in the development of the netback price and as a result provides an overstated netback price which disadvantages domestic gas consumers. This is the point the MEU has made in previous submissions to the ACCC on this topic. In those earlier submissions the MEU provided evidence as to what a market price is for converting gas to LNG.

In February and October of 2018, the MEU provided submissions to the ACCC regarding the development of a LNG gas net back pricing approach which the ACCC would release on a regular basis, providing both historical and forward-looking views on what the price of natural gas at Wallumbilla might be, based on the spot LNG spot price in Asia. In addition to these written responses, the MEU also discussed the aspects of the MEU response with ACCC staff.

In its responses, the MEU raised a number of issues, but the MEU considers that the final approach used by the ACCC errs in that it has included costs in the netback price that delivers a higher netback price than appropriate, leading to domestic consumers paying more for the gas they need.

In the discussions the MEU had with ACCC staff, it was pointed out by the ACCC that it had had many discussions with the LNG producers about the costs the LNG producers incur, and what savings the LNG producers consider they get when the gas is sold domestically rather than exported. The producers opined that they need to recover a return on and return of the capital invested on all sales they make regardless as to whether the sales are for export or domestic use. The ACCC appears to have accepted this view when they developed their netback price approach.

The MEU points to the essential fallacy in the LNG producer's (and now the ACCC's) argument. The commitment to build the export facilities was made on the basis of long-term contracts which would have to have included the return needed on the investments made. Project financing of such large capital works would have implicitly required this to obtain the needed debt provisions to make the projects viable. Further, the owners of the facilities would have similarly required the value of the export contracts to cover their commitment prior to making a final investment decision. As the LNG market is relatively competitive, with significant LNG exports from a number of different countries and owners, for the developers to have assumed that they would be able to sell gas in addition to their contracted gas supplies, and at full recovery (ie that the surplus capacity will be sold at a price providing full recovery and that the surplus capacity will be fully utilised) is not consistent with a project financing approach.

In a similar vein, the MEU points out that the LNG producers have contacted with pipeline providers to deliver the gas to their export facilities from the gas wells and so regardless of the amount of gas flowing, the exporters would have had to incorporate the full cost of this pipeline capacity in their contracted volumes. This runs in the face of the view put by the exporters to the ACCC that they can only offer the marginal cost of transport when the gas is sold domestically. Again, this assumption is false. In the price for the export of the LNG, the producers will have included the full cost of the paying for the pipelines' capacity (excluding any potential additional sales), so any gas sold domestically does not add to the cost the producers are already incurring and which has been recovered in the contracted sales. If the producers are the only shippers on a pipeline, the pipeline owner will require the shipper to pay the full cost of the pipeline, regardless as to capacity used at any time. Even if there is no flow, the shipper is still required to pay the agreed tariff. This means that the contracted price for sales of LNG must have included the full recovery of the cost for transporting the gas to Gladstone.

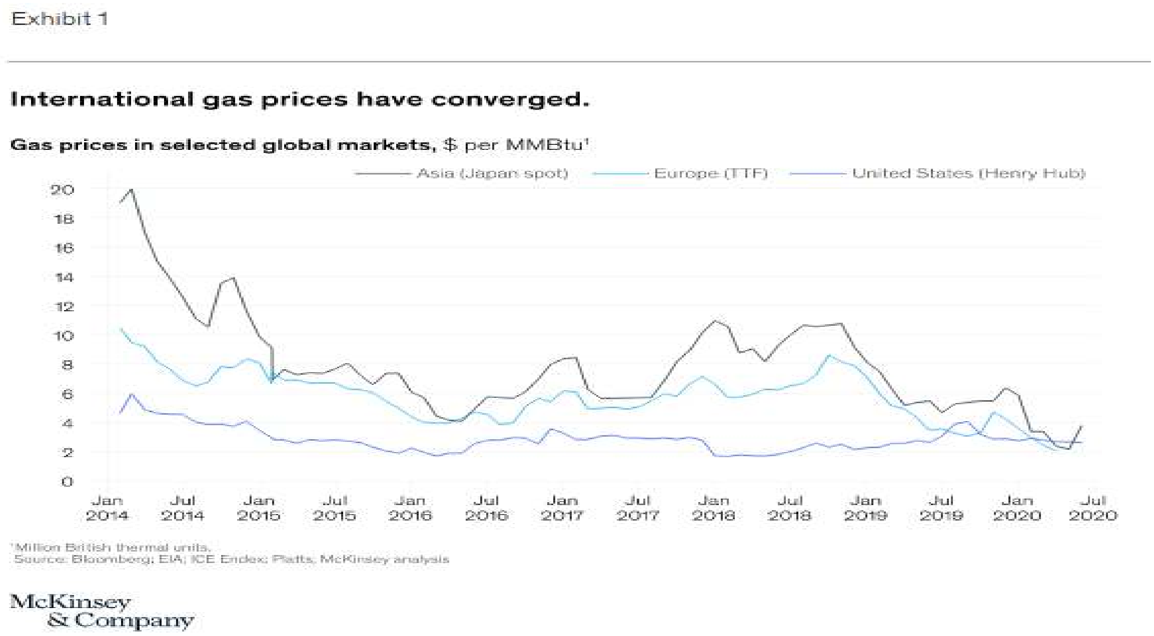
As the MEU commented in its 16 October 2018 submission:

> "The MEU considers that the netback price should be based not only on the LRMC for shipping but also on the LRMC for processing of gas and using a published price for transport of gas from Wallumbilla to Gladstone. Further, the cost for processing of gas should be tested against prices that are offered by LNG processors to third parties seeking to use spare capacity that a processor might be willing to sell."

LNG price bases

It is very clear that the growth of LNG is heavily biased towards the NE Asia market and India. At the same time there is considerable growth in supplies of LNG from the US and Qatar and from sources other than Australia. The outcome of this is that there will be increasing calls for more spot price shipments (eg as India has already initiated in recent years) and less on long term contracts. Essentially, the increasing competition will lead to more spot acquisition for gas supplies and a market just for LNG[1] rather than it being "oil linked".

The current netback price for the domestic market is based entirely on Platts JKM. This was assessed as appropriate as the bulk of Australia's exports are to north east Asia and Australia is (just) the dominant provider to NE Asia. However, with the growth of LNG trade, especially from North America, the NE Asia supplies are less reliant on Australia LNG and becoming less so. This means that the NE Asia market is merging in terms of price with other markets as seen in the following chart included in a September 2020 McKinsey report[2]



[1] As distinct from one based on the market for oil

[2] https://www.mckinsey.com/industries/oil-and-gas/our-insights/the-future-of-liquefied-natural-gas-opportunities-for-growth

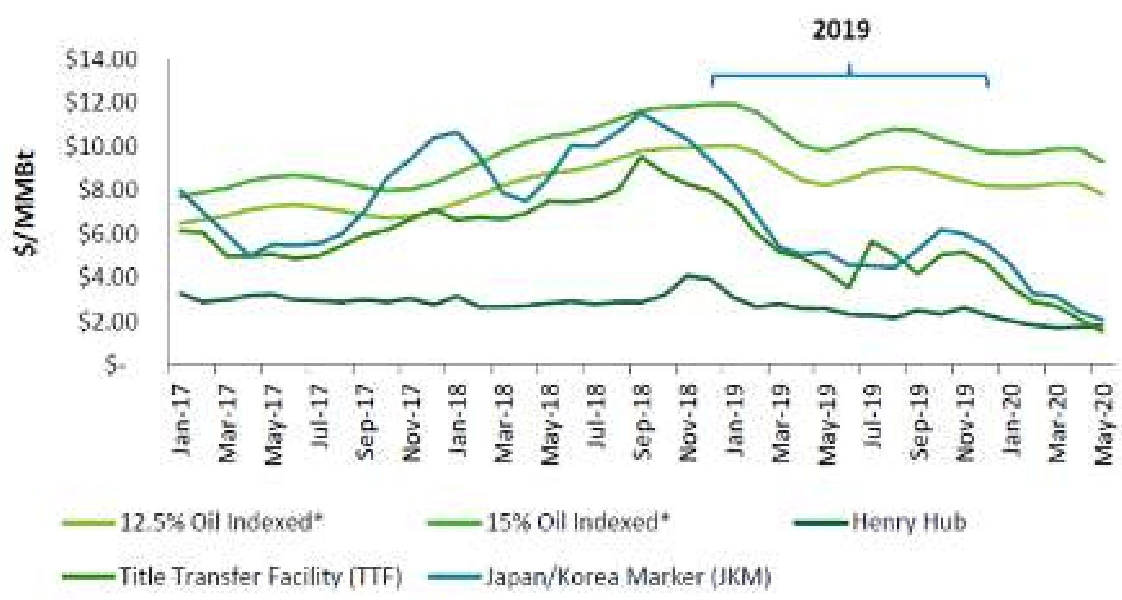
This clearly implies that there is value in using a number of different base prices (particularly Henry Hub) for gas as a starting point for establishing the netback price.

The MEU particularly considers that the Henry Hub price[3] should be included in the analysis as it is clear that the export potential for LNG ex the US is an appropriate comparator, especially as Henry Hub has a high degree of liquidity that is not so apparent in other markers, especially noting this liquidity is evident for the longest forecast periods. Further, it is clear that over the next two decades, LNG exports from the US will dominant the market by a significant margin as outlined in the Issues Paper on page 20.

The MEU is not convinced of the value of oil-linked pricing for the netback price or the domestic gas market. While the MEU is aware that there are a number of LNG contracts that are oil-linked, this reflected the early years of LNG contracting where there was no spot price or any other appropriate marker available – apparently more and more contracts for LNG are not oil linked. However, the MEU is aware that with the massive growth of LNG trading, the need to link LNG with oil prices has significantly declined and already there are moves to implement a separate LNG market independent of the oil price movements.

The ACCC provides a good example of this disconnect with its chart (Figure 3) highlighting this divergence and reinforcing the divergence noted above.

Figure 3: Movements in LNG and gas price markers



With this in mind, the MEU does not consider that the ACCC should implement a netback price based on oil derivatives but should use a number of different LNG price sources, especially those supplying LNG from the Henry Hub.

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[3] Henry Hub could well be used as an international LNG price basis as there are publicly available tolling arrangements available for processing NG to LNG as is shipping from the US to various ports with LNG demand.

Netback price tenor

The MEU points out that the contract terms available for domestic gas have been traditionally 3-5 years, with some contracts being longer. As the supply of gas as feedstock and for thermal needs is an essential element of the cost build up for many manufacturers to provide the highest certainty of recovery of the investments the manufacturers have made, longer term gas contracts are preferred over short one. The current contract term for gas supplies is about 2 years, with many firms contracting even shorter in the hope that prices will reduce from their currently unsustainable high levels.

With this in mind, the MEU considers that a longer tenor forecast netback price is not only desirable but necessary to assist gas buyers in negotiating the optimum price, recognising that with the limited options for competitive gas supplies, such negotiations are quite one-sided in favour of the sellers.

A netback price for the next 5 years on an annual basis (ie with a futures price for each year) would be of distinct advantage to gas buyers if this could be made available.

In conclusion, the MEU supports the continuation of the netback prices series but with some modifications:

- The deductions for processing to LNG and haulage to Gladstone should be at a full cost value (ie at LRMC) and not marginal cost (ie SRMC) as the ACCC currently uses.
- The benchmark bases should be on KJM but also other markers. In particular, Henry Hub prices (adjusted for other costs) should be used due to its extensive liquidity compared to other markers.
- The tenor of the netback price should be longer with no shorter than 5 years if possible.

The MEU was and remains a strong supporter of this process and we would like to discuss this matter further to explain our views in more detail so we request you contact our Public Officer (David Headberry) on [redacted] or at [redacted] to arrange a time for this to occur.

Yours sincerely

[redacted]

David Headberry
Public Officer