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13th July 2015

Keir Delaney
Secretary
Environment & Planning Committee
Parliament House, Spring Street,
Melbourne VIC 3002
epc@parliament.vic.gov.au

Dear Mr Delaney

RE: Inquiry into unconventional gas in Victoria

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 and Rheem) whose goal is to prosecute a range of policy issues to help ensure a strong and vibrant future for the sector.

Across Australia, and in Victoria, our members have made substantial investments in manufacturing facilities. They operate dozens of plants and administrative facilities across the state, providing ongoing employment to thousands of people, both as employees, subcontractors and through flow-on, indirect business activity. Most of these facilities rely on gas, either as a major energy source or as an input to supply. They are also highly trade-exposed. It is therefore critical that Victoria's gas is supplied out of a transparent, competitive and liquid gas market if manufacturing in this state is to remain viable.

As was noted in the 2013 report by the Victorian Gas Market Taskforce: "Victoria has enjoyed cheap and reliable natural gas for many years but those days are fading fast... Victorians should be under no illusions. Rising gas prices will have a negative impact on Victoria's manufacturing base. Jobs and investment are at risk.[1]"

Our members, particularly those reliant on gas, watch inquiries such as this with more than a keen interest. Ideally, we would be at the point of not needing them at all, such is the urgent need for development and reform of the gas market.

The actions governments and regulators take over the next 12 -18 months are critical if we are to avoid a crisis that threatens the livelihoods of thousands of Victorians and could see many of these proudly Australian-based companies send their operations offshore to countries with a more competitive supply environment. In some cases, this is already happening. For example, in 2014, the price of gas, and the inability to secure a long-term contract, was a key factor in Incitec Pivot Limited's decision to build a US$850 million ammonia plant in Louisiana rather than in Australia. Conversely, CSR's decision to close a

[1] http://www.energyandresources.vic.gov.au/about-us/publications/Gas-Market-Taskforce-report, p.2

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glass factory in Sydney in 2013 was informed by the availability of cheaper gas in Victoria and the difficulties with securing competitive long-term gas in NSW. The price of gas in Victoria over next few years will also determine whether the company invests $80 million to re-furbish the Dandenong glass factory or seeks other alternatives, such as investing in offshore manufacturing capacity or overseas supply agreements.

Contrary to some forecasts, it should therefore not be regarded as a forgone conclusion that industrial gas demand is in decline along the east coast.

The recommendations and subsequent implementation of this inquiry's findings, as well as the ACCC's current east coast gas market review and recommendations, will have major implications for the cost competitiveness and viability of our members' businesses as well as for other manufacturing industries and consumers in Victoria.

A viable onshore gas industry in Victoria forms an important part of changing the current east coast gas market landscape, which faces supply shortages and high prices for domestic customers. Onshore gas could play a critical role in increasing supply along the east coast, and to Victorian manufacturers in particular, at a competitive price. However, allowing development of these resources will not be enough. Market reforms, such as those highlighted below (and canvassed in other recent gas market inquiries and reviews) are also critical if we are to secure industrial gas use for Victorian manufacturers and save jobs. Currently, the shifting supply of Victorian gas to meet the demands of the export markets to the north is undermining these goals.

MA's specific interest in this inquiry relates to issues around affordability of supply for domestic industry (Terms of Reference 4a and b) and the implications for local and regional development, investment and jobs (Terms of Reference 4c).

Arguments relating to the other terms of reference (such as safety implications of unconventional gas and community engagement etc) are outside of our primary concern, although we note the emergence of a scientific consensus in relation to the safety of unconventional gas exploration. When subject to rigorous environmental, community and regulatory oversight, and an evidence-based approach to measuring the impacts of unconventional gas exploration and development, we see no valid reason why unconventional gas should not be developed in Victoria.

Current issues in the gas market

1. Rising wholesale gas prices and supply uncertainty

As members of the committee would be aware, Australia's east coast gas market is undergoing a profound structural change, caused primarily by the rapid development of a LNG export industry, which will see a trebling in demand for gas from the east coast of Australia as it links to markets in Asia.

While there are significant benefits to Australia of a major LNG export industry on the east coast, the impact on domestic downstream gas users – both industrial and residential – is

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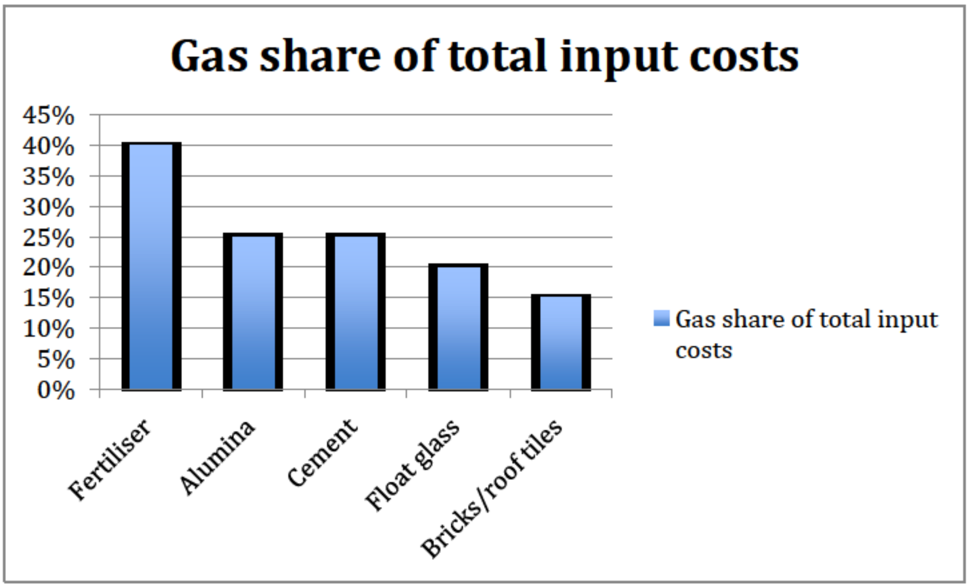
substantial. The LNG boom has already seen gas prices double or triple previously contracted prices - from $3-4 per gigajoule to the current gas price of up to $10/GJ.

Much of Australia's gas resources are being committed by the resource owners to their LNG operations, making these resources unavailable to domestic users of gas - which represents a tiny portion of the world market. Our members believe that in some cases, they pay higher prices than export netback pricing (as far as can be ascertained in the absence of a liquid and transparent domestic gas market).

Modelling by Deloitte Access Economics[2] shows that supply constraints, market dysfunction and higher gas prices will have impacts across the economy including mining, agriculture, electricity and water, construction and trade, transport and commercial & services.

The industrial impact is especially felt in the manufacturing sector. Natural gas is essential to a range of manufacturing industries, both as a feedstock in manufacturing plastics and chemicals (Australia's second-largest manufacturing sector) and fertilisers and explosives (which support Australia's two primary export industries agriculture and resources); and as a favoured energy input in other manufacturing, especially alumina, bricks, cement, float glass, steel, glass container manufacturing, paper and roof tile production.[3]

For example, natural gas makes up 15-40% of the cost base of fertiliser, alumina, cement, float glass, brick and roof tile production. Most of these industries are also trade exposed, competing with imports or exports from lower cost countries, often with access to lower cost domestic gas (e.g., US, Middle East, Russia) – putting the earnings, investment and overall viability of our domestic manufacturers at risk.



² Deloitte Access Economics, *Gas market transformations – Economic consequences for the manufacturing sector,* July 2014
³ Manufacturing Australia, *Impact of gas shortage on Australian manufacturing* May 2013 p.3

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With its significant gas usage and high trade exposure, the Australian manufacturing sector is projected to decline by up to $120 billion by 2021[4] unless this issue is addressed urgently, with projections also suggesting between 13,000[5] – 83,000[6] direct manufacturing jobs are at risk.

Recent analysis by EnergyQuest predicts a 133 PJ 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 decade[7]. This shortfall could force some factories to close during high demand periods and puts upwards pressure on price.

2. Lack of competition and transparency

The rapid expansion of the sector has also included dramatic consolidation within the east coast domestic gas market, with just six parties now controlling around 90% of our vast gas reserves.[8] A similarly small group control almost 90% Australian gas production. The recent proposal by Royal Dutch Shell to acquire BG, currently being reviewed by the ACCC, would consolidate the market even further.

At the present time, only a small fraction of reserves are made available to the Australian domestic market and domestic supply appears restricted to a small number of potential suppliers. The challenge of securing supply is so great, several manufacturers have been forced to take matters into their own hands. 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 could or would consider and is indicative of market dysfunction in relation to domestic supply.

Improving competition and transparency is crucial to restoring confidence in the domestic gas market.

The role for the Victorian Government in gas market reform

The Federal Government and national regulators have a critical role to play in reforming the east coast gas market. However, many reforms can be pursued by the Victorian Government. As Australia's manufacturing state, the Victorian Government should be playing a lead role. The goals of market reform should include:

1. Restore competitiveness to the domestic gas market
2. Improve gas supply security

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

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3. Develop gas infrastructure for Australia's future
4. Encourage new gas producers to enter the market.

1. Restore competitiveness to the domestic gas market

The Australian Energy Market Operator and the ACCC should be the primary drivers of reform in this area. However, the Victorian Government should consider facilitating the development of a liquid and competitive gas hub and a gas price exchange, with spot and futures markets, to facilitate price discovery and provide a reliable price signal - key attributes of a competitive natural gas market.

Critical to achieving this is the entrance of multiple suppliers. Naturally, price discovery and liquid markets cannot evolve in a market with only one supplier. A deep and liquid market is supportive of new entrants, but more comprehensive reforms and new arrangements are required other than simply establishing a contract on the ASX. Price discovery is key, and therefore steps should be taken to ensure joint venture marketing is deconstructed and contract details and pricing move into the public arena.

This would necessarily involve financial institutions as providers of liquidity and trading services and should operate with a view to support greater integration – rather than fragmentation – of existing trading arrangements. Improved transparency of pipeline capacity information and trading will be critical if the market is to function adequately.

The steps towards developing effective gas supply hubs have been previously examined and outlined in various studies, including:

- Market Reform (joint author with AEMO) "*Evolution of the Gas Supply Hub*"[9];
- International Energy Agency, "*Developing a Natural Gas Trading Hub in Asia, Obstacles & Opportunities 2013*"[10];
- "*AEMC East Coast Wholesale Gas Market and Transmission Pipeline Frameworks Review*", Victorian Department of Economic Development[11].

2. Improve gas supply

As stated above, it is in the interests of Victorian industry (and consumers) for the Victorian Government to allow onshore gas development, without delay. This would be best facilitated by:

- adopting a transparent, three-tiered approach to sharing gas royalties with landholders, immediate neighbours and the local community;
- providing additional incentives, such as differential royalties treatment, where gas remains undeveloped; and,

[9] http://www.marketreform.com/viewpoints/
[10] https://www.iea.org/media/freepublications/AsianGasHub_WEB.pdf
[11] Public Forum, 25 February 2015

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- developing and supporting a National Regulatory Framework to streamline and standardise regulations relating to gas exploration and production.

In addition, the government could support policies to restrict hoarding or withholding gas from the domestic market. This could be achieved through either a “use it or lose it” policy (whereby producers lose their gas reserves if economically viable projects are not brought to market in a reasonable timeframe), or by charging a fee for sitting on undeveloped acreage – effectively a storage cost.

3. Support the development of robust gas infrastructure for Victoria’s future

The government should identify strategic “energy corridors”: regions or zones that are crucial to future energy needs, either for resource extraction, pipelines or other infrastructure, if and where there are gaps in our understanding. Planning should also support improved interconnectivity between supply and demand centres.

Open access to infrastructure is critical. A deep and effective market cannot be developed if new or existing small gas suppliers are locked out of use of well-established infrastructure. Long-term contracts which lock up transport and processing regardless of utilisation create near insurmountable barriers to entry for new gas suppliers. Reform of this area is critical, hand in hand with market and resource access reforms.

4. Encourage new gas producers to enter the market

The government should restrict the capacity of any one entity, joint venture, or partnership to control a large or dominating share of reserves, while promoting entry of new competitors from the point of resource control and extraction.

The government should also look to remove any existing barriers to entry at all possible market entry points, especially access to pipeline capacity and transportation. Substantial economies of scale in pipeline operation tend to favour pipeline monopolies. The commercial and regulatory arrangements for transportation across transmission pipelines are therefore critical to facilitating trade in gas and competition in upstream and downstream gas markets. 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.

Conclusion

In summary, the delays to exploration and development of Victoria’s onshore gas reserves has impacts that extend beyond the oil and gas industry. The ability of Victoria’s manufacturing industry to access competitively priced, and preferably local, gas is imperative if we are to see these industries remain in the state. Given the long lead time between exploration and development of reserves, the moratorium on development should be lifted as soon as possible, so that Victorian manufacturers can have some confidence

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that their future gas needs can be met.

In addition, the process of gas market reform must continue, at a pace that accommodates the pressing needs of domestic industrial gas users to secure competitively priced, and long-term, gas contracts. Any additional, short-term measures that the Victorian Government can pursue outside of the national reform process should be undertaken.

MA does not advocate retrospective reservation of gas supply. However, if the market does not change significantly in the next 12-18 months, governments (both state and federal) are likely to face mounting calls for emergency gas reservation to prevent widespread offshoring of gas-intensive manufacturing.

Do not hesitate to get in contact should you wish to discuss this submission in more detail.

Yours sincerely,

[redacted]

Ben Eade
Executive Director
Manufacturing Australia