



21 September 2016

Mr I Blayney MLA  
Chairman  
Economics and Industry Standing Committee  
Parliament House  
West Perth, WA, 6005

Dear Mr Blayney,

The DomGas Alliance welcomed the opportunity to address the Economics and Industry Standing Committee on the issue of the compilation and accuracy of the annual Gas Statement of Opportunities (GSOO).

The Alliance also took the time to attend the Committee session on 7 September 2016 where officials from AEMO presented evidence.

The Alliance is particularly concerned that significant sections of the evidence provided by AEMO was misleading or incorrect.

We are concerned that the evidence could give the Committee a false impression or understanding of issues affecting the GSOO.

By highlighting some of these misleading statements, the Alliance hopes to provide further information and clarity to the Committee to assist in its deliberations. The Alliance in no way is suggesting the statements were deliberately misleading but they should be corrected all the same.

Perhaps the most egregious of these misrepresentations came in the views expressed by AEMO about the willingness of LNG producers to supply into the domestic market.

The AEMO evidence left the strong impression that LNG producers were willing to supply into the domestic market at prices below LNG netback.

The views expressed by AEMO do not accord with market experience and, of even more concern, do not reflect the stated assumptions presented in the GSOO document itself. It is also contrary to public statements made by major LNG producers such as Woodside, which make it clear that LNG netback is their benchmark for domestic sales.

The following comments address these concerns in chronological order from the transcript of evidence.

1. In response to a question from Mr Norberger, Mr Parrotte stated:

Our view is—we have seen it over the years—that an LNG back supply will put gas into the domestic market if the price is right, predominantly because they get that return right there and then rather than waiting for a future outcome. Certainly, AEMO was seeing that on the east coast as well. It is actually a little bit newer over there in terms of the LNG facilities in Queensland, but we are already starting to see the LNG- based facilities are putting gas into the domestic market. Even this morning, APA have announced the build of an \$80 million or \$100 million pipeline to connect an LNG facility to the domestic market because they are seeing that there is going to be a shortage and they will be able to get a return on that investment.”

Firstly, this is misleading as AEMO tries to conflate the East Coast market with the West Coast market. The two markets are fundamentally different – a statement of fact so obvious that it almost should not need to be mentioned.

The Queensland example references on-shore gas piped to an LNG facility. All of Western Australia’s LNG projects are offshore piped to an on-shore plant.

The AEMO evidence references an announcement by the APA pipeline group that a bi-directional pipeline would be built to link the Wallumbilla gas hub to an existing pipeline that feeds the APLNG plant at Gladstone.

It should be noted that the link is bi-directional – that is, it allows APLNG to take gas from the Wallumbilla gas hub while giving it the option to supply back into it.

The impression left by the AEMO evidence is that LNG producers are willing participants in the domestic market. The caveat on Mr Parrotte’s statement is “if the price is right.”

As The Australian newspaper noted on the day of the announcement:

“The \$24.7 billion Australia Pacific LNG project has commissioned a pipeline south so it can sell surplus Queensland coal seam gas previously planned for export to hungry domestic buyers, *as tight east coast gas markets push prices higher than those of spot LNG exports.*”<sup>1</sup>

The Australian had previously reported:

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<sup>1</sup> “Australia Pacific LNG builds domestic pipeline”, The Australian, 6 September 2016

Gas pricing figures for the largest industrial users prepared for the federal government show *increases of up to 113 per cent in some parts of Queensland* -between 2002 and last year. The food and grocery lobby has warned that *the forecast tripling of gas prices between 2014 and 2021* would cost its members \$9.7 billion and result in 3000 job losses, “significantly larger than the output impacts of the carbon tax”.<sup>2</sup>

In other words, the rush to LNG exports has led to a domestic gas shortage and a rapid escalation in domestic gas prices. That escalation in prices had now led to a situation where APLNG can receive a better domestic price than for LNG on some spot cargoes.

Apart from the fact the AEMO evidence also conflates a spot market situation with Western Australian industry’s need for long term contracted gas, the announcement quoted hardly is good news for Australian domestic gas users. It simply confirms that LNG producers will supply the domestic market – if they can get a better price than LNG netback.

Finally, it should be noted that while Mr Parrotte’s example references the willingness of a Queensland-based LNG producer to engage in the domestic gas spot market, this is of no relevance to the Western Australian GSOO, which clearly states:

“It is also important to note that short-term gas contracts are not considered in the forecasts due to the relatively small scale of the short-term market.”<sup>3</sup>

2. Evidence given by Mr Parrotte and Mr Tan in response to Mr Tinley’s question about “how confident are you that you are getting told what you need to be told to make an accurate statement to the market” was confused, to say the least, and did not inspire any great confidence.

AEMO appeared to be saying that it was at fault for not asking the question soon enough or not putting an early enough deadline for the information because, on two occasions involving the same company, information was not provided in time to be included in the GSOO.

It stretches credibility that the same company could be involved in the same mix up two years running.

There is either something wrong with the way AEMO (then the IMO) exercised its powers or there is an appearance that one company dragged its feet or did not provide sufficient information in the first instance, which then required a formal AEMO follow-up request.

<sup>2</sup> “Gas crisis fears drive reform on CSG projects”, The Australian, 18 August 2016

<sup>3</sup> Gas Statement of Opportunities, November 2015, Page 56

It is surprising that these issues were not referenced in the relevant GSOO.

The DomGas Alliance urges the Committee to recommend that all future instances where information is not provided or not provided in a timely manner should be noted in the GSOO, including which party is at fault. From the evidence provided, it would appear AEMO was at fault on these occasions, albeit there is the possibility that one company was simply gaming the system.

It is a pity the Committee did not have further time to probe this part of the AEMO evidence as it goes to the heart of the question of whether AEMO is exercising the powers given to it by the Parliament to the fullest effect.

**3.** A subsequent example of evidence given by AEMO about its assumption that LNG producers would supply into the domestic market at prices below LNG netback should be contested.

Following a statement/question by Mr Norberger where he referenced enough gas being available at LNG netback pricing, the Chair asked:

**The CHAIR:** So when you assess supply, is that based on the assumption that producers will not supply into the domestic market below LNG netback?

**Mr Parrotte:** No. We believe that they will supply into the domestic market at a price that is right for them. We get some insights from them—some might be above, some might be below—but each organisation will need to make that call themselves. Our view is, and what we have seen, is that they will make gas available as long as it is above their cost of supply. That is definitely the floor. If it is above the cost of supply, then they will do it simply to bring forward a cash revenue that they would otherwise forgo for some period of time.

Shortly thereafter followed this exchange between the Chair and Mr Tan:

**The CHAIR:** Do you have any way you can measure companies' willingness to supply?

**Mr Tan:** The potential gas supply is a measure of the willingness to supply.

**The CHAIR:** So how do you put that into your report?

**Mr Tan:** First, we do a projection of oil prices, and it is an oil-linked formula, and based on that we project what LNG would be, and based on that we calculate a netback price. The netback price is only a maximum cap for LNG-linked facilities, and the minimum is the production cost. So the domestic price actually floats in between that and it never exceeds LNG netback. For domestic-only facilities, the minimum price is production cost and the top price is a real return of plus 25 per cent. That is how it has been managed.

Mr Parrotte's comments could be misinterpreted as suggesting LNG producers will supply below LNG netback. This is not what has been stated publicly by companies such as Woodside.

Mr Tan's comments are perhaps more misleading. The GSOO does measure "willingness to supply", not actual supply or even intent to supply. It is a process of asking producers how much they would be willing to supply into the market at the price point estimated by AEMO for the purposes of compiling the GSOO.

In Section 3.2 "Potential gas supply forecast methodology" of the 2015 GSOO, AEMO identifies how it models the willingness to supply concept using pricing forecasts.

This section states that:

"The model also assumes a linear relationship between additional (uncontracted) supply and the domestic gas price."<sup>4</sup>

This is logical enough: the higher the price, the more likely a producer is to supply.

But it then states that this assumption is applied as follows:

"For LNG-linked facilities, all spare capacity (subject to the availability rate for the facility) is assumed available for uncontracted supply *if the domestic gas price reaches or exceeds the LNG netback price*;<sup>5</sup>

Mr Tan's comments that "the netback price is only a maximum cap for LNG-linked facilities" creates the impression that AEMO does not consider the price expected by LNG producers will exceed LNG netback. (The Committee's 2011 Inquiry into Domestic Gas Prices considered evidence of prices above LNG netback.) When taken with Mr Parrotte's earlier comments, the impression created is that LNG producers will supply into the domestic market at lower prices (somewhere above production cost) but with LNG netback as the maximum.

This is not what the GSOO model states.

The Western Australian markets heavy reliance on domestic gas from LNG projects will continue into the future. So the desire of LNG producers to achieve LNG netback or better for their domestic gas sales will continue to influence domestic prices and negatively impact demand.

What is puzzling about the 2015 GSOO is that it forecasts LNG netback prices to rise but continues to show excess "willingness to supply" at lower domestic prices.

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<sup>4</sup> Gas Statement of Opportunities, November 2015, Page 45

<sup>5</sup> Gas Statement of Opportunities, November 2015, Page 45

For example, the GSOO's Table 3.7 (Forecast gas price parameters, 2016 to 2025) shows that the base price for LNG will US\$8.90 in 2022. Subtracting the liquefaction costs of US\$3.25, the price comes in at US\$5.65, a rough measure of LNG netback. Using the conversion rate in the table, this equates to a low-end price of AUD\$8.97. Yet Figure 3.6 from the GSOO shows the predicted low-end average domestic price in 2022 at around \$7. Referring back to Figure ES.1 (Domestic gas market balance, 2016 to 2025), the GSOO predicts that even on the base case the domestic market will face a significant over-supply.

Given that LNG-based projects will still be supplying around 40-50% of domestic needs, even with the tapering off the NWS contracts, it appears to be a brave assumption that they would do so to such an extent on a price that is roughly 20% below what could be obtained on the export market.

The future "willingness to supply" charts contained in the GSOO are clearly based – as noted in the assumptions for model – on LNG producers obtaining LNG netback or higher for their domestic sales.

Further on in Section 3.3.5, "Domestic gas price forecasts", the 2015 GSOO notes the IMO's (AEMO's) view that:

"anticipated improvement in the US economy and likely increases in US interest rates, will increase LNG netback prices in Australian dollar terms. This should drive an increase in domestic gas prices despite lower forecasts for Asia Pacific LNG prices." <sup>6</sup>

This would appear to be confirmation that the domestic price is linked to the LNG netback price and, logically, nowhere would this link be stronger than for LNG producers with a gas reservation obligation to market their gas into the domestic market.

In light of that, it is not credible for AEMO to leave the Committee with the impression that LNG producers will supply below LNG netback.

**4.** The following exchange between the Chair and Mr Tan in relation to the Pluto gas project cannot go unchallenged as the Committee may be interested in whether AEMO is exercising all the powers provided to it by the Parliament:

**The CHAIR:** On a similar vein, how do you factor into the GSOO supply from new projects like Pluto?

**Mr Tan:** We have spoken to them, and last year they provided us with information relating to Pluto, which was published in the GSOO.

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<sup>6</sup> Gas Statement of Opportunities, November 2015, Page 56

There is nothing contained in the 2015 GSOO which provides any new information about how or when Woodside will deliver on its domestic gas obligation from the Pluto project.

The GSOO, after quoting existing sources such as the Committee's 2011 Inquiry into Domestic Gas Prices, simply states:

"The IMO understands Woodside is in discussion with the Department of State Development. The IMO has not received further advice on the timing of any domestic gas supply from Pluto LNG."<sup>7</sup>

If the Committee is looking for an example of where AEMO has failed to effectively use its extensive powers to gain the most basic of information from producers, this is it.

There is information contained in the GSOO regarding Pluto's LNG exports but the Chair's question specifically related to domestic supply, not export requirements.

5. The Committee asked several questions in relation to how AEMO measures its performance, including this exchange:

**Mr P.C. TINLEY:** That is qualitative and that is good, but quantitative as well; how well have you picked the price?

**Mr Parrotte:** We do look backwards. We look at what the forecast price was and the supply was and we will compare that in the GSOO.

**Mr P.C. TINLEY:** What you said?

**Ms Kapani:** Yes.

**Mr P.C. TINLEY:** How do you come up?

**Mr Tan:** We compare it with published information from the Department of Mines and Petroleum.

**Mr Parrotte:** How did we go last year?

**Mr Tan:** We were two terajoules up.

Mr Tan's response appeared to impress Committee members and we do not question its accuracy.

However we would note that it is a misleading measure of the accuracy of the GSOO and is a bit of a red herring in regards to the Committee's purpose of assessing the forecasting relevance and value of the GSOO.

Mr Tan's response appears to relate to the real outcome of gas supply in one year, based on a prediction or forecast made in the previous year's GSOO.

Given that the North West Shelf has been providing in excess of 50% of domestic supply and that this has been done under existing and known contracts, it would

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<sup>7</sup> Gas Statement of Opportunities, November 2015, Page 64, 65

hardly be surprising to accurately forecast a supply result for 12 months down the track.

The importance or true value of the GSOO for policy makers should be in the veracity of its long-term forecasts. It is a relatively simple task to forecast what supply may be available to the market over the next 12 months. Policy makers need to know what will happen beyond 2020, when the existing North West Shelf contracts have expired. If we are to face supply shortages or significant demand destruction (and associated industry closures and job losses) in the post-2020 period, policy makers need to understand that now so that remedial action or alternative options can be pursued.

In summary, the DomGas Alliance found the evidence of AEMO to be defensive but unconvincing. There appeared to be no acknowledgment of the significance of the concerns expressed by domestic gas users and little understanding that these concerns will not be resolved by increased consultation.

As noted in our opening statement, the GSOO needs to be a robust and credible document and therefore the processes that underpin the GSOO need to be robust and credible.

We are not convinced that this is the case.

The Domestic Alliance is grateful for the Committee's efforts in regards to this issue and again acknowledges its longstanding interest in the future of domestic gas supply in Western Australia.

Yours sincerely

MATT BROWN  
Executive Director