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To: Department of Climate Change, Energy, the Environment and Water
Re: Proposed Extension of AEMO's East Coast Gas System Reliability and Supply Adequacy Functions

Thank you for the opportunity for the Institute for Energy Economics and Financial Analysis (IEEFA) to provide input to the Department of Climate Change, Energy, the Environment and Water (DCCEEW)'s consultation on the Proposed Extension of AEMO's East Coast Gas System Reliability and Supply Adequacy Functions.

IEEFA is an independent energy finance think tank that examines issues related to energy markets, trends and policies. The Institute's mission is to accelerate the transition to a diverse, sustainable and profitable energy economy.

IEEFA is broadly supportive of the proposed extension to the Australian Energy Market Operator (AEMO)'s powers and provides the following high-level feedback. IEEFA notes that:

- The government's design of the recently announced domestic reservation scheme could reduce uncertainty about future gas supply and therefore help to reduce barriers to investment, particularly in gas transmission and storage infrastructure

- An overemphasis on supply-side measures risks imposing higher costs on gas users, particularly if accessible, financially beneficial opportunities to reduce gas demand are not prioritised alongside supply measures. It is vital that governments also prioritise demand reduction measures, which in addition to reducing household and industrial energy bills will also improve the supply-demand balance and provide greater certainty to the gas industry on future demand (noting demand risk is a key uncertainty impacting on investment).

- The setting of a "reserve price" under the proposed "LT RSA [long term reliability and supply adequacy] tool" to support gas supply and/or infrastructure projects will ultimately determine the costs borne by end users. Where the tool is used to support infrastructure projects that exhibit natural monopoly characteristics, there is a risk that reserve prices will reflect monopoly prices to the detriment of the efficient operation of the market.

IEEFA welcomes the opportunity to engage further on the matters raised in this submission.

Kind regards,

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Given the prospects of structural shortfalls in the east coast gas market, IEEFA supports the proposed extension to AEMO's powers. However, we note that greater policy certainty will help to improve investment certainty and possibly minimise the need for AEMO's functions to be extended.

The east coast gas system is in a transition, with legacy gas fields being depleted and gas demand in decline. As noted in the consultation paper, this transition, along with tight supply resulting from market concentration, has contributed to heightened market uncertainty and its resulting impact on supply-side investments.

IEEFA also notes, however, that recent government interventions have undermined investment certainty and impacted on supply-side investments. The potential for further regulatory interventions, to address underlying issues in the gas market, creates ongoing and additional investment risks, which effectively increase the risk premium for new investments.

A credible reservation scheme will improve investment certainty and minimise the role for AEMO

The ongoing uncertainty highlights the critical need for a credible reservation scheme to improve outcomes in the east coast gas market and enhance investment certainty. In the absence of a scheme that will actually increase domestic supply of lower-cost gas, and therefore address broader concerns about gas market conditions, the industry is likely to face ongoing uncertainty, particularly if gas producers anticipate further regulatory interventions in future. In IEEFA's view, the proposed reservation scheme should be designed to ensure additional domestic supply of gas held by the Queensland liquefied natural gas (LNG) exporters, which is relatively low cost and able to be supplied quickly.

The Gas Market Review's final report outlines a range of principles to guide detailed design of a reservation scheme that will apply to LNG exporters, including "respect" for existing LNG contracts, a 2027 start date, and flexibility for LNG exporters in how they meet their domestic obligations. Collectively, the principles are, in IEEFA's opinion, ambiguous and open to interpretation, which likely reflects the fact that government is still weighing a range of considerations in its design of the reservation scheme.

In IEEFA's view, the government should design the scheme in a way that requires additional gas from Queensland LNG exporters, who control most of the reserves in eastern Australia and are well placed to quickly increase domestic gas supply.

While a detailed discussion of the proposed reservation policy is beyond the scope of this submission, IEEFA nonetheless notes that a reservation scheme that requires additional supply in Queensland will help to address uncertainty around gas supply and provide greater investment certainty to market participants.

For instance, APA Group is yet to reach final investment decision (FID) on stage 3 of its East Coast Gas Grid Expansion Plan, which would increase north-south gas transmission capacity by

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24%. In IEEFA's view, greater certainty about the availability of gas in Queensland would increase the likelihood of APA Group reaching FID on the critically needed upgrade to its transmission network.

Crucially for AEMO, it would incentivise market-led solutions and reduce the likelihood that AEMO would need to exercise its Gas System Reliability and Supply Adequacy Functions. This would likely go some way to addressing industry concerns about the potential impact of extending AEMO's functions.

Prioritising demand reduction will help to address the risks of shortfalls and improve investment certainty

As noted in the consultation paper, future gas demand remains a key uncertainty faced by the gas industry. Future demand will be influenced by a range of factors, including renewable and battery storage penetration and generation, industrial closures (particularly of larger gas users), and residential and industrial electrification. This uncertainty is exacerbated by uncertainty about future gas supply and prices, which in turn impacts on forecasts of future demand.

While demand downside risks undermine investment certainty for industry, they also affect the likelihood and magnitude of possible gas shortfalls. Expressed differently, lower demand may actually help to improve the demand-supply outlook and mitigate the risks of shortfalls, provided demand falls sufficiently quickly. As noted in the consultation paper, demand is not falling as quickly as supply.

There is an opportunity for governments to implement further policies to drive a quicker and more orderly managed reduction in eastern Australian gas demand. This would also reduce residential and industrial energy bills, while also providing greater certainty to gas producers and infrastructure developers about future demand levels.

If implemented quickly, demand reduction measures could also impact on the likelihood and magnitude of potential future gas shortfalls. IEEFA research based on AEMO estimates in 2023 and 2024 respectively found that demand reduction policies could fully address the risks of annual shortfalls in the southern states, and of peak day shortfalls in Victoria. While AEMO's estimates of future gas demand and supply have since changed, and it is not clear if the policy interventions modelled by IEEFA would still fully address the risks of shortfalls, they would nonetheless materially reduce gas demand.

IEEFA acknowledges and welcomes the August 2025 commitment by energy ministers to "further work to reduce gas demand" and to "further work on projecting gas demand". In IEEFA's view, this work must be prioritised given the predominant focus on supply-side measures in recent years has not sufficiently reduced the risks of shortfalls.

From a first-principle perspective, it is also clear that a holistic focus on both supply- and demand-side measures is more likely to address the risk of shortfalls at a lower cost to consumers. This in part reflects new gas developments' tendency to be more costly, particularly

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for those located further from demand centres (thereby requiring significantly more transmission infrastructure), meaning a supply-side focus is more likely to result in more expensive gas coming to market.

Reserve prices should reflect efficient market pricing

While improved certainty about gas availability, particularly in Queensland, and future demand should underpin further supply-side investments, IEEFA acknowledges that investment uncertainty and the risk of shortfalls may persist. For this reason, IEEFA supports the introduction of the proposed LT RSA [long term reliability and supply adequacy] tool, but cautions that it should be used as an absolute last resort.

That said, IEEFA has concerns that the proposed approach to setting reserve prices could result in higher costs for consumers, particularly with respect to infrastructure exhibiting natural monopoly characteristics.

As outlined in the consultation paper, it is proposed that the reserve price would be set as follows:

- For gas infrastructure projects, it would be based on:
    - Prices agreed to in any foundation contracts already executed; or
    - The price level that would equate revenue with the determined fixed or floor revenue amount if all capacity was sold (as set out in contractual arrangements).
- For gas supply projects, it would be:
    - Zero; or
    - Set at an amount that would maximise gas sales revenue.

In 2022 the Australian Competition and Consumer Commission reported that transmission pipelines across eastern Australia continue to price infrastructure access on a "monopoly pricing" basis, resulting in higher costs for shippers under executed contracts, and ultimately for gas end users.

As infrastructure becomes more important for system supply and security, there is potential for infrastructure operators to seek to increase access prices. APA Group's Dandenong LNG storage facility provides a pertinent example. A change in the pricing model resulted in a material increase in effective storage prices under contracts, resulting in lower utilisation and a regulatory change to allow AEMO to contract capacity at the facility.

By setting reserve prices based on prices in foundation contracts, under which users may face monopoly pricing, there is a clear risk that the reserve price will in effect reflect the market power of the infrastructure provider.

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This risk may be lessened where the reserve price is set to equal the agreed fixed or floor revenue amount. However, this will ultimately depend on how that amount is agreed between AEMO and the proponent (the consultation paper does not provide detail on this aspect).

While infrastructure operators that receive investment support from AEMO will be subject to regulation, this will not address the risks of higher-than-efficient access prices. For this reason, IEEFA urges the department to consider either:

- Requiring all supported infrastructure projects (that exhibit natural monopoly characteristics) to be subject to full regulation (with carve-outs where government support is provided to upgrade existing facilities);
- Requesting the Australian Energy Regulator to undertake a form of regulation review for all supported infrastructure projects; or
- Setting fixed and floor revenue amounts based on cost recovery principles for reasonable infrastructure construction costs.

IEEFA recognises that there are trade-offs associated with the proposed amendments which will need to be considered. This includes impacts on investment incentives and development timelines. However, these impacts need to be balanced with ensuring gas users do not pay inefficiently high prices.