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Reviewing Key Proposals by the COVID-19 Advisory Board To Subsidise the Gas Industry

The Government Is Attempting To Pick Winners but Has Chosen a Loser

Overview

The National COVID-19 Coordination Commission (Advisory Board) (NCC) has proposed a number of 'natural' gas industry measures for a post-COVID economic recovery in Australia.

Instead of gearing the country towards a marked investment in industries that will shape our long term future, the NCC's proposals are not only largely focussed on subsidizing and energizing the flailing gas industry, they are *not* market based and in fact will expose the government to significant long term liabilities.

Depending on how energy markets continue to operate, the NCC's gas subsidy proposals have the potential to cause significant long-term economic damage to Australia.

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The NCC wishes to expand the role of government to be more like a socialist state than that of a market economy. The measures outlined in the NCC's interim report[1] has government wearing the burden of industry, while throwing all of the risk of markets, pricing, credit and demand onto the taxpayer at a time when budgets are stretched.

The oil and gas industry is in a long term slump, only exacerbated by the coronavirus. The industry is riddled with major write-downs and bankruptcies, across the board.

For example, in Australia, the three lead companies in the consortium that own the three export coal seam gas (CSG) to liquefied natural gas (LNG) plants at Gladstone have written off over $24bn since 2014 on their failed investments.

[1] This briefing note is written based on the NCC's Interim report. To the best of IEEFA's knowledge, the government is not looking to release the NCC's final report.

IEEFA considers it is financially irresponsible for the government to pursue the NCC's proposed gas subsidy measures to prop up a failing gas industry.

How *Not* to Pick Winners

Key Measures Proposed by the NCC

The measures proposed in the NCC's interim report raise three key issues:

1. The government would be extending soft loans to small and mid-cap exploration and production companies.

2. The government would be acting as the buyer - at a fixed price - of all production from fossil gas fields, and then would be on-selling that gas to consumers.

3. The government would be underwriting volumes in pipelines, which essentially means the government would be guaranteeing returns to pipeline operators, thereby taking on all of the volume risk in a volatile market.

Each involves the government bypassing the market and attempting to "pick winners".

1. The government would be extending soft loans to small and mid-cap exploration and production companies.

The NCC wants the government to back, with cheap loans, high risk small and mid-cap gas explorers.

The NCC's interim report suggests the government should:

> *b) Provide support, such as low cost capital, to existing small and mid-cap market participants – promote current field development and avoid a supply/demand imbalance in 12-24 months' time; target basins with infrastructure to connect to markets; consider incentives to ensure there is bridging supply available as we come out of this current low oil price investment environment.*[2]

The risks involved in doing this type of loan book are extremely high. Picking winners in this area of the market is extremely difficult even for seasoned bankers. It is bound to end in disaster.

[2] NCC. Interim Report. Page 8.

2. The government would be acting as the buyer - at a fixed price - of all production from gas fields, and then would be on-selling that gas to consumers.

The NCC wants the government to underwrite supply - which means to be the buyer of the gas at a fixed price under a long term contract - and then to on-sell it to smaller customers who would then be responsible for transport of the gas to their destination of use.

The NCC's interim report suggests the government should:

> *Phase B: Create the market, lower the cost & complete the network*
>
> *3. Create the market*
>
> *a) Underwrite supply at priority supply-hubs, to 'create the market' – underwrite upstream gas volumes at fixed prices in line with demand; allow participants to trade around the positions, so the government never takes possession of the molecules – essentially aggregating the 'book build' of demand and matching users to the long-lead production development in a parallel process. Potentially aligned with UNGI program.*[3]

In this proposal, the government would essentially be taking on all of the market and customer risk in gas distribution, leaving the gas industry with only the production risk.

This scenario is exactly what happened in the Northern Territory with the 'take or pay' contract that the Northern Territory government signed to underwrite Eni Australia's Blacktip gas field in the Bonaparte Gulf. The arrangement cost the Northern Territory's government owned utility, the Power and Water Corporation, dearly, as it ended up not being able to take all of the gas, but still had to pay for it. The NT government then had to commit taxpayer funds to build a pipeline to sell the gas. Total losses from this fiasco have not been disclosed.[4]

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Do we really need to repeat past mistakes? Proposing that the Australian government be the buyer of gas for the gas industry is a regurgitated failed policy.

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[3] NCC. Interim Report. Page 9.

[4] For a more detailed explanation of this classic piece of policy failure see: The Australia Institute. Fracking and Slacking. May 2020. Page 22-24.

3. The government would be underwriting volumes in pipelines.

The NCC is proposing that the Australian government ensure fixed returns to pipeline companies by underwriting volumes in gas pipelines.

The NCC's interim report suggests the government should:

> *a) Take active, participatory role in strategic pipeline developments – proven precedents (e.g. Norwegian government in North Sea, original Cooper Basin, Moomba to Sydney ethane line, original construction of Dampier Bunbury Pipeline (DBP) in Western Australia) in taking a non-operating equity position, minority share, or underwriting position to ensure large reductions in energy cost are delivered.*[5]

The NCC is proposing that the Australian government underwrite volumes in gas pipelines to ensure fixed returns to pipeline companies.

Australia already has a very generous regulatory environment for gas pipeline developments.[6] The government does *not* need to underwrite volumes. It exposes the taxpayer to unacceptable risks - risks that should be bourne by the private sector.

If the government underwrites volumes in pipelines, it would be particularly beneficial to pipeline companies as it totally de-risks what is increasingly becoming a high risk investment. Gas usage in Australia is falling as high prices encourage energy switching, with gas usage for gas powered generation in the national electricity sector declining by 58% since 2014.[7]

Globally, gas usage is also down considerably. U.S. exports of LNG have fallen 75% this year.[8] The U.S. is the third largest exporter of gas in the world after Australia and Qatar.[9]

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The Australian Energy Regulator (AER) came out with their 'State of the Energy

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[5] NCC. Interim Report. Page 9.
[6] Michael West. It's a gas! Australian gas is a bargain…if you're Japanese. 15 July 2020.
[7] AEMO. National Electricity & Gas Forecasting.
[8] EIA. U.S. liquefied natural gas exports remain at low levels this summer. August 2020.
[9] Department of Industry. Resources and Energy Quarterly. June 2020. Page 67.

Markets 2020' in June.[10] In the preface the chair, Clare Savage, essentially says gas infrastructure assets will be stranded if gas transmission and distribution networks do not convert to hydrogen:

> *"The national gas industry could also undergo significant change as some jurisdictions move towards a zero carbon emissions policy. This could have significant consequences for the future of gas pipeline networks. In response, the AER recently supported the future recovery of Jemena's investment in trialling the production of hydrogen from renewable energy for injection into its Sydney network. If hydrogen trials such as Jemena's prove successful, the natural gas networks could be re-purposed to distribute hydrogen. If not, the economic life of the assets could be limited."*

Effectively, the chair of the AER is calling 'time' on a multi-billion dollar industry.

If the government is proposing to underwrite the volumes in pipelines, it is also essentially guaranteeing the volumes of gas in pipelines for private companies.

In eastern Australia, the two most likely companies that would be the beneficiaries of this largesse would be APA group, an Australian listed public company, and Jemena. Jemena is owned by the governments of Singapore and China. Essentially, underwriting volumes implies the Australian government would be guaranteeing the profits of a pipeline company owned by two foreign governments.

In the NCC's proposals, all returns are going to the gas industry.

If the government sees a bright future for gas, against its own experts' advice, an alternative solution would be setting up a government-owned pipeline company so that the taxpayer could get a return.

In the NCC's proposals, all returns are going to the gas industry. This would make the industry very happy, as indicated by the peak lobby group APPEA in May:

> *"We believe that a successful future for Australian oil and gas will consist of developing the currently uneconomic or stranded discovered gas resources that abound through Australia's hydrocarbon regions. Using this gas is vital to extending the economic life and utility of existing gas and LNG infrastructure and thus maximise value from these assets."*[11]

Jemena has the added detraction of currently being under investigation by the Australian Tax Office for tax evasion.

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[10] AER. State of the Energy Market 2020. Page 1.
[11] APPEA. New oil and gas investment needs policy stability. May 2020.

> *"The Australian Taxation Office (ATO) is currently conducting a transfer pricing audit in relation to the Company's convertible instruments."*[12]

The amounts involved are not trivial. It has been estimated that Jemena's tax evasion could cost the taxpayer $500 million in unpaid taxes, a figure that IEEFA considers reasonable.[13]

The government should not subsidise tax evading companies.

Gas-fired NCC Proposals Are High-Risk

All of the gas-fired measures proposed by the NCC have high risks attached to them in the current economic environment.

In addition to the global economic downturn and subsequent bankruptcies in the oil and gas industry, there is also a global glut of gas. At present there are LNG tankers circling in the ocean looking for a home for their unwanted cargoes.

As put by the gas industry peak group APPEA:

> *"The current market conditions are arguably the most challenging the industry has ever seen with demand destruction, excess supply and oil prices falling more than 75 per cent over the first four months of 2020."*[14]

The Australian Energy Market Operator (AEMO), the only agency to model a future electricity grid in its Integrated Systems Plan (ISP)[15], has shown that by 2040, the role of gas in a renewable rich grid is smaller than today.

However instead of planning to enable this transition, the NCC proposals would use taxpayer funds to steer capital into higher-cost, high emission forms of energy.

Gas use in residential and commercial applications can largely be substituted for cheaper electrical heating in the form of air conditioners, induction cooking and heat pumps for hot water. It's now cheaper for the consumer to switch from gas.[16] [17]

On a global scale, the risks of gas infrastructure *not* seeing out their economic lives is high due to evidenced and calculated climate change risks. We are seeing the possibility of carbon tariffs being levied on high emitting countries such as Australia.[18]

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[12] Jemena. 2019 Annual Report. Page 18.
[13] Environmental Justice Australia. Fracking the Northern Territory. Page 6.
[14] The Australian. Oil and gas reform blueprint amid fears sector struggling to recover from COVID-19 oil crash. July 28, 2020.
[15] AEMO. 2020 Integrated Systems Plan. July 2020.
[16] Melbourne Energy Institute. Switching off gas - An examination of declining gas demand in Eastern Australia. 26 August 2015.
[17] Environment Victoria. A Gas-free recovery? New report shows how phasing out gas will benefit all Victorians. 3 June 2020.
[18] Politico. Europe threatens U.S. with carbon tariffs to combat climate change. December 2019.

Every State and Territory in Australia has some sort of net zero emissions target by 2050. However, there are inherent conflicts in policy responses between State and Federal government policies. Producing and consuming more gas is fundamentally non-aligned with current State and Territory government policies on emissions, as they are emissions reduction policies.

Methane emissions from unconventional gas fields and along the supply chain are high and when burned in peaking plants and used for export, are no better for the climate than coal.[19]

Summary and Conclusion

The NCC's proposals to subsidise the gas industry via the government taking on significant risks that are normally assumed by the private sector is a strategy of dissolving normal market conditions in favour of a socialist system of market governance, similar to that managed by many emerging countries such as China, Indonesia, and Venezuela, to name a few.

If the government is going to assume such risk, it should also be the entity that receives the appropriate market-based rewards. The NCC's proposals create a structure whereby all of the risks will be carried by the government (and therefore taxpayers) and all of the rewards will be garnered by the gas and pipeline companies. It is a classic tale of privatise the profits and socialise the losses.

If the NCC's proposals are agreed to, the government will be subsidising an energy intensive high emitting industry at the very time we need to reduce emissions to comply with State governments targets for net zero emissions by 2050 and reduce further climate risk in the form of bushfires, drought, flooding and erosion, and other catastrophes. We cannot achieve these targets by producing and consuming more fossil gas.

[19] IEEFA. Is the Gas Industry Facing Its Volkswagen Moment? March 2020.

About IEEFA

The Institute for Energy Economics and Financial Analysis (IEEFA) 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. www.ieefa.org

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Energy Finance Analyst– Gas/LNG Bruce Robertson has been an investment analyst, fund manager and professional investor for over 35 years. He has worked for major domestic and international institutions, including Perpetual Trustees, UBS, Nippon Life Insurance and BT. Bruce is an active participant in the national debate on energy issues in Australia and has been invited to present to numerous government enquiries into the electricity and gas industries.