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GAS CURBS TO DELAY REFORM

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They'll harm both LNG exports and national interests

LNG export restrictions recently announced by Prime Minister Turnbull were based on false premises and ignored the dynamic consequences. Consequently, they'll diminish — not improve — Australia's overall economic welfare.

Turnbull claimed that domestic gas prices were higher than those in markets we export to and that contract prices being offered to domestic buyers were "four or five times" US prices. However, the first claim isn't true, while the second is dangerous and irrelevant.

Turnbull claimed that some domestic buyers were being offered prices of $20 a gigajoule, that these were "way above the export price" and "should be half that or less". However, in doing so, he made two apples-with-oranges comparisons: long-term contract prices versus spot prices, and landed LNG prices at port versus domestic gas prices delivered to customer premises.

Take Japan, our biggest LNG export market. In principle, Japan's domestic gas prices could be higher or lower than ours. One the one hand, there are extra costs associated with LNG imports. On the other hand, Japan's LNG market is much more competitive than our domestic gas market, as the world's many LNG exporters compete to sell in the world's biggest market.

Nevertheless, a 2016 ACCC inquiry found the evidence did not support claims that domestic prices were higher than gas prices paid by overseas users importing LNG. Those claims are still made, but the evidence still doesn't support them.

I analysed the latest data available on monthly spot prices in Australia and Japan prior to Turnbull's announcement. The average landed spot price of LNG exports to Japan contracted in March was $US6.20/MMbtu (or one million British thermal units). Adding conservative estimates of other buyer costs (such as regasification) gives a wholesale cost at distribution entry point of about $A10/GJ. That's higher than AEMO's average March gas spot prices at the Brisbane and Adelaide hubs for March ($A8.24/GJ and $A9.77/GJ, respectively), although below the average price at the Sydney hub ($A10.90/GJ).

Turnbull's comparison of long-term contract prices in Australia with spot prices in Japan is spurious. Long-term contract prices offered at a point in time reflect expectations of spot prices over the term of the contract (which may be many years). If spot prices are expected to rise over that time, then of course long-term contract prices will be higher than spot prices — in both Australia and Japan.

Further, his reference to the US is baffling. The US produces 97 per cent of what it consumes. Until now, its exports have been tiny and largely by overland pipeline. With little capacity to export or import LNG by ship, US gas prices have been driven by local factors — in particular, enormous subsidies to natural gas (including shale gas).

If Turnbull wants Australia to be like the US, here's what he'd have to do: subsidise natural gas to the tune of billions of dollars per year and shut down Australia's LNG export facilities. This might reduce domestic gas prices, but it would dramatically harm Australia's economic welfare.

In any case, low US gas prices have recently spurred the development of US LNG ship exports. The evidence shows that US exporters sell at exactly the same landed prices in export markets as Australian exporters do.

However, Turnbull made one valid point: domestic gas prices don't fully "reflect international export prices". The netback price (final sales price less variable costs) on LPG exports is below the netback price on sales into major domestic destination hubs. Gas at AEMO's Wallumbilla hub can be piped to either LNG export facilities near Gladstone or major domestic destination hubs. My estimated March average LNG export netback price at Wallumbilla of $A6.20/GJ is about $A2.50/GJ below the March average netback price at Warrambilla for gas sold into Sydney.

Why? Suppliers allocate sales between markets to maximise profits. Profit-maximising cost/price mark-ups are lower in markets with the greatest supply-side competition.

While Turnbull said that his government "remains committed to LNG exports, but not at the expense of Australian interests", his restrictions will harm both LNG exports and Australian interests.

In theory, as netback prices are higher on domestic sales than on LNG exports, diverting some gas from exports to the domestic market might produce a net gain in the short-term (gains to domestic consumers may exceed the losses to suppliers). However, this possible gain is far eclipsed by the dynamic costs that the restrictions will generate.

There are much better ways to keep domestic prices down. The ACCC has highlighted two. First, improve regulation of gas pipelines, which account for a high proportion of domestic end-user prices. Second, enable new sources of gas supply — hence more competition — by reducing restrictions imposed by state governments. A free market would also respond to keep domestic prices in check if necessary. For example, LNG receiving terminals could be built to generate more supply and competition from imports. AGL was investigating this option before Turnbull's announcement.

Turnbull's claim that his restrictions are "temporary" is wishful thinking. As Milton Friedman once warned, nothing is so permanent as a temporary government program.

The big problem is that the restrictions will stymie necessary government reforms and market responses. Turnbull says that "the long-term goal remains boosting the supply of gas by removing state restrictions". But that shouldn't be a long-term goal. As the ACCC has said, it's an "urgent need". Yet if Turnbull's restrictions reduce domestic prices in the short-term, governments will feel less pressure to lift supply restrictions and better regulate pipelines, while market participants will have less incentive to respond.Paul Kerin is Adjunct Professor in the University of Adelaide's School of Economics.

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