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Gas Market Consultation
Labour Market, Environment, Industry and Infrastructure Division
The Treasury
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Submission to: A mandatory code of conduct to guide behaviour in the market

Introduction and summary of Woodside's position

During 2022, the East Coast wholesale gas market experienced historically high prices because of unusually high, and unexpected, demand for power generation. As a result, the Federal Government passed laws in December 2022 to allow intervention in the gas market. One intervention method is through a proposed mandatory code of conduct for gas market participants (**Mandatory Code**) which is not yet available but is the subject of industry consultation.

Woodside recognises its responsibility to respect the environment, operate safely and provide low-cost, lower carbon energy to customers. Consistent with this, Woodside has been supplying reliable and affordable domestic gas to Australian households, manufacturers and power generators for more than four decades.

Woodside voluntarily signed the Australian Gas Industry Code of Conduct (**Voluntary Code)** which we saw as consistent with Woodside's commitment to fair and transparent processes in the domestic market. Given the extensive time committed to the development of the Voluntary Code, we would anticipate that it would be the basis for the Mandatory Code.

Woodside acknowledges that wholesale gas prices were not at sustainable levels during 2022. However, the extraordinary intervention in gas markets creates a risk of unintended consequences. It could make gas supply agreements more difficult to negotiate, gas more expensive and, in the long term, less available. Woodside believes the Mandatory Code will result in industry uncertainty, leading to reduced liquidity and lower investment in gas supply. In the long run, the Mandatory Code will likely have the effect of increasing, not decreasing, wholesale gas prices.

If the Mandatory Code is imposed, it should apply to all gas market participants, including retailers and wholesale traders, in order to share responsibility and accountability.

The proposed arbitration mechanism should be a last resort and should not become a regular outcome of negotiations. Such an outcome would lead to reduced market confidence and lower liquidity. Gas prices should be set by market forces, predominately influenced by suppliers and buyers negotiating commercially and in good faith. Prices should not be set by arbitrators through litigation.

We set out our specific observations and comments on the framework in the table below.

We look forward to working with Government to address both the matters in the consultation paper and to playing our part in ensuring domestic gas supply, which can support the transition to a lower carbon future.

Response to Consultation Paper Questions

Our responses in the table below assume the Mandatory Code will apply only in the East Coast gas market.

Questions	Comment
1. Are the obligations outlined in the voluntary code (summarised at Appendix C), if made mandatory, adequate to address bargaining power imbalances between gas suppliers and purchasers in the negotiation of gas supply contracts?	From November 2020 to December 2021, gas producers (represented by APPEA) and gas customers (represented by Australian Industry Group, Chemistry Australia, Energy Users' Association of Australia and Manufacturing Australia) negotiated the details and provisions of the Voluntary Code in consultation with the Federal Government and the Australian Competition and Consumer Commission (**ACCC**). The Voluntary Code is, therefore, the product of extensive industry/government engagement. Subject to our comments below, the Voluntary Code is a reasonable basis for a Mandatory Code. Woodside does not agree with the proposition that there is a bargaining imbalance between gas suppliers and large-scale sophisticated purchasers in the negotiation of gas supply contracts. This position is demonstrated by Woodside's multi-decade ability to successfully execute sales agreements that are acceptable to us and the buyer, which have included a mixture of domestic retailers, generators and commercial industrial customers. These buyers are sophisticated and have chosen to manage their wholesale gas supplies through a mix of direct contracting and spot market exposures in line with their corporate risk profiles. Furthermore, the price spike that occurred in the east coast market in mid-2022 was not a result of a bargaining imbalance but a confluence of factors, both short- and long-term, including colder than average winter, intermittent renewables generation, increased unreliability of coal generation and under-investment in new supply. If broad enforcement mechanisms are imposed under the Act in respect to compliance with the Code, then the Voluntary Code does not provide the level of certainty required for a mandatory code of conduct. For example, clause 18 of the Voluntary Code states that a Gas Supplier will not be taken to have breached clause 15 (the obligations to deal with each other in good faith within the meaning of the "Unwritten Law") on the basis that it is acting in accordance with its "legitimate commercial interest". Participants will require guidance on what is a "legitimate commercial interest", especially given that its interpretation can lead to arbitration, breach of law and/or enforcement action. It will also be important to apply the Mandatory Code to gas customers and other gas market participants. This can ensure that there is shared responsibility and transparency of information in the industry. In Woodside's view, Treasury should also confirm: 1. the Mandatory Code cannot re-open contracts entered into before the Mandatory Code commences. The alternative is likely to cause uncertainty in the market and supply delays as the volume of contracts to be renegotiated is likely to increase. Equally, variations to existing contracts should not bring these contracts within the ambit of the Mandatory Code; and 2. as with the Voluntary Code (clause 40), once a gas supply agreement is entered into, a dispute or complaint made in

relation to that gas supply agreement is governed by the terms and conditions of that gas supply agreement and not the Mandatory Code. Imposing the Mandatory Code over and above the terms **already agreed** after negotiations between the parties is likely to cause uncertainty in contracting, delay supply and increase the likelihood of disputes.

In clause 41 of the Voluntary Code, Woodside queries the utility of having an acknowledgement of LNG netback pricing and the ACCC Gas Inquiry and considers they should be removed from a Mandatory Code, as these will not be relevant factors to domestic gas pricing.

2. Should the Code of Conduct be limited to wholesale contracts where the supplier is a gas producer, or be expanded to include contracts offered by other market participants, such as retailers? This need not broaden the application of the reasonable pricing provision.

Shared responsibility can be achieved through shared regulation

The Mandatory Code, including the reasonable pricing provisions, should apply to all gas market participants including retailers, pipeline operators and wholesale traders to ensure that reasonable pricing flows through to consumers. This is likely to be helpful to smaller buyers which purchase lower volumes from gas retailers and have limited bargaining power.

The factors that may need to be considered to determine what pricing is reasonable in context will vary between gas market participants. Failing to apply reasonable pricing obligations to retailers and wholesalers creates the potential for opportunistic behaviour by those who may seek to on-sell gas at higher, unregulated prices. For example, the $12 price cap under the *Competition and Consumer (Gas Market Emergency Price) Order 2022* (Cth*)* only applies to gas producers and excludes retailers. This creates an immediate opportunity for retailers to buy gas at prices under the price cap, without any controls over any mark-up in re-supply.

The behaviour of retailers will need to be monitored closely, and the Mandatory Code provides an avenue for such regulation that the current price cap does not.

Woodside supports the premise that while the price cap is in effect, any base price below the price cap should be considered "reasonable" and not be subject to arbitration.

Beyond the price cap period, the price cap should not be a signal as to what may be reasonable, as the price cap reflects a temporary emergency measure and will not necessarily reflect prevailing market conditions in future years. The price cap should not be considered a de-facto "reasonable price" outside of the price cap period.

It will be important to clearly distinguish the price cap (and ACCC guidance on the price cap) from the reasonable pricing provisions under the Mandatory Code. Some market participants are already beginning to conflate the two regulatory instruments by referring to $12/GJ as the reasonable price for beyond 2023. A separate and specific approach needs to be clarified in the Mandatory Code for reasonable pricing to avoid the market setting future prices based on a temporary, emergency price cap. See Question 6 for our further comments on the reasonable pricing provisions.

3. How could the binding arbitration process be designed to ensure resolution in an efficient and cost-effective manner,

Participants should be incentivised to avoid arbitration except as a last resort, by including mandatory negotiation periods before arbitration is permitted.

particularly with regard to reasonable pricing?

An arbitration should be by a sole arbitrator and the arbitration process (or other determination process) should be focused on determining whether the supplier has complied with its Mandatory Code obligations. Where the arbitration concerns the issue of whether a supplier has complied with the reasonable pricing provisions:

1. if the arbitrator determines that the price offered is not compliant (i.e. not reasonable), the arbitrator may determine a compliant price, provided that the price is determined at the **maximum** of what he or she considers reasonable and without regard to any expired price cap; or

2. If the arbitrator determines that the price offered complies with the reasonable pricing provisions, the gas supplier is the successful party in the arbitration and that offered price must be used for the supply.

The costs of the arbitration should be borne by the unsuccessful party, to incentivise compliance from suppliers while discouraging purchasers from engaging in opportunistic or unmeritorious referrals to arbitration.

Participants to a dispute should have an opportunity to agree on the arbitrator to be appointed pursuant to a specified process. If the parties cannot agree on an arbitrator to be appointed, the Mandatory Code should specify the body responsible (which should be an arbitral institution that is reputable and reliable) for appointing an arbitrator and administering the arbitration.

The body should compile and maintain a panel of qualified individuals with gas price experience from which an arbitrator could be selected to ensure the process of selecting an arbitrator is streamlined and expedited. The participants in each arbitration, including the arbitrator, should be subject to confidentiality obligations which require that they only use information obtained during the arbitration for the purposes of that arbitration, subject to the usual appropriate carve outs.

4. On what grounds should a party to a gas supply agreement negotiation be permitted to refer a dispute to a binding arbitration process? Should mediation be a pre-condition to accessing arbitration?

Woodside submits that the factors set out in its response to Question 6 below provide reasonable grounds for reference when determining whether an offered price is reasonable (after the price cap is no longer in place). A party should be entitled to refer a dispute over an offered price to arbitration to determine whether an offer is compliant with the reasonable pricing provisions. The arbitrator's discretion should be limited to determining whether the price offered is compliant in the first instance. If the arbitrator determines that the price offered is not compliant (ie not reasonable), the arbitrator may determine a compliant price, provided that the price is determined at the maximum of what the arbitrator considers reasonable and without regard to any expired price cap.

In respect of any expression of interest (EOI) process, a buyer participating in such an EOI should not be able to challenge any outcome which is a result of its own proposed price terms. For example, a buyer should not be able to propose a price, and then subsequently seek arbitration that the price the buyer itself offered was unreasonable.

As far as non-price terms are concerned, arbitration should be limited to whether the terms offered are compliant with any minimum standards for those terms included in the Mandatory Code. No arbitration should

be available in respect of terms for which no minimum standards are so prescribed by the Mandatory Code.

As arbitration should be a process of last resort, it would be appropriate for mediation to be completed within a specified time frame as a mandatory pre-condition for arbitration.

5. On what basis should an arbitrator be able to make a determination on price?

If an arbitrator is to make a decision on an offered price, the basis for that determination should reflect the contents of the reasonable pricing provision, which we note is still under development. As noted above, the determination should be made on the basis of whether the price proposed by the supplier is compliant with the reasonable pricing provision (which we believe as a minimum should reflect all items listed in our response to Question 6 below) and, if compliant, the buyer may choose to accept it or not.

Where the decision maker determines that the price offered by the supplier is **not** reasonable, the arbitrator should determine a price that is the maximum it considers reasonable, with justifications provided. The arbitrator should not determine a price that is lower than the maximum price that the supplier could legitimately offer to discharge its reasonable pricing obligations. Otherwise, buyers will be incentivised to arbitrate all prices offered by producers through the Mandatory Code's dispute process.

6. What factors should be considered for the reasonable pricing provision?

We understand that the reasonable pricing provisions for producers may be based on producers' efficient long-run marginal cost of domestic supply, plus a commercial return on capital. Woodside objects to this proposal and is strongly of the view that the costs associated with bringing gas to market extends beyond long-run marginal cost alone and should include costs from across a producer's portfolio and its assets' entire life cycle, capturing both historical and prospective spending.

Woodside submits that a focus on only long-run marginal cost would place the onus on the producer to tie its pricing to the cost of production, rather than the market. This can have unintended pricing outcomes, including limiting price as an investment signal to attract new investment by potentially resulting in asymmetric returns.

This is particularly relevant in the case of depressed market conditions in the future, where market forces could foreseeably drive market prices below reasonable pricing for periods of time. In turn, this could drive producers' rates of return, over the life cycle, below that assumed to be achieved by a reasonable pricing level.

This is a risk that producers accept with free market movement of prices. However, a mechanism that caps producers' ability to recoup returns over the commodity cycle will deter investment if pricing does not take account of the full commodity cycle, including periods of low or negative returns.

The proposed principles are common in the context of access to infrastructure constituting a natural monopoly. In such cases the aim of price regulation is an outcome that would be expected in a workably competitive market. It is predicated on the owner having the opportunity to recover the economically efficient cost of investing in natural monopoly infrastructure over its economic life in circumstances where buyers do not have genuine alternatives to using that infrastructure in order to participate in dependent markets.

The proposed Mandatory Code applies in a different context in which there is already competition between suppliers and buyers have choice. It is our view that the reasonable pricing provision should not be based solely on the proposed principles but should reflect the market context in which it applies (including any unique features/terms and conditions of a given transaction), by including principles relating to:

- life cycle cost of supply including basin exploration write-offs, and from across a producer's relevant portfolio of costs, rather than focus only on a notional asset;
- acquisition costs and stamp duty (where applicable);
- allowance for taxation and royalties;
- depreciation based on the economic life of the new development(s);
- ongoing operating expenditure;
- a rate of return consistent with the risk profile of gas exploration and production companies;
- past pricing, to the extent it impacts reasonable rates of return over the life cycle;
- anticipated decommissioning costs;
- the impact oil price indexation may play in a contract;
- prevailing prices in the market at the time of the offer;
- the price at which the supplier is likely to be able to sell an equivalent volume of gas to a third party;
- the financial capacity of the buyer (especially if pricing is ultimately subject to arbitration);
- risk allocation within contracts, for example a producer's liability for failure to supply is likely to increase in a reasonable pricing environment as compared to standard supply arrangements;
- the features and associated costs and benefits of the gas supply (for example, it is reasonable to charge a higher price for firm gas supply compared to as available or interruptible supply, or for flexible buyer commitments that can adjust to fit the shape of demand); and/or
- the legitimate commercial interests of the supplier and / or credit worthiness of buyers.

In addition, gas sale agreements often provide for services beyond gas delivery, including storage and capacity services. For example, Woodside is able to provide secure supply to the East Coast market during winter gas peak periods under its 'commodity and capacity' model, and these services play an important role in ensuring certainty of supply of gas in the market. If reasonable pricing is required, the Mandatory Code should expressly exclude such capacity services from reasonable pricing provisions. The alternative would discourage producers from entering into combined commodity/capacity contracts, which may cause uncertainty of supply for retailers.

7. What type of guidance on reasonable pricing should be provided to support negotiations, and if necessary, arbitration?

At a minimum, the provision ought to specify and clearly define the categories of items that should or should not affect the reasonable price and contain clear guidance on the appropriate calculations and formulas. Some possible factors, such as forecast demand and supply profiles, may be less specific than others. In an energy transition landscape, the supply and demand profiles are particularly susceptible to change. In these cases, it may be useful for the reasonable pricing provision to provide examples of how these factors can be taken into account in determining a reasonable price, to minimise uncertainty regarding whether the price is compliant.

8. What design features will ensure the reasonable pricing provision provides a sufficiently clear basis for producers and buyers to negotiate a price?	We repeat the comments made in response to Question 7 above. In addition, reasonable pricing should also take into account each party's next best alternative, the relevant market conditions including in the downstream markets that the gas is being used for (for example, where the gas will be acquired for re-supply, where it will be consumed in a power station, where it will be consumed for manufacturing), the value and cost of non-price terms and conditions, and the prevailing market price for gas.
9. What model of arbitration should be used to resolve disputes about reasonable pricing?	We refer to our response to Question 3 above. In addition, the Mandatory Code should: • refer to specific rules of a reputable arbitral institution that will apply to any arbitration under the Code; and • incorporate specific Code rules that reflect the factors that the arbitrator can take into account when determining whether a pricing proposal is reasonable (refer the Question 6 for Woodside's submissions on a reasonable price). If an arbitrator is to make a decision on an offered price, the basis for that determination should reflect the contents of the reasonable pricing provision. The determination should be made on the basis of whether the price proposed by the supplier is compliant with the reasonable pricing provision and, if so, the buyer may choose to accept it or not. Where the decision maker determines that the price offered by the supplier is not reasonable, the arbitrator should determine a price that is the maximum the arbitrator considers reasonable, with justification provided to the parties, or identify how such a price should be calculated. It remains unclear whether it is proposed that an arbitrator will be able to determine the other terms and conditions of that proposed supply, and if so, how those terms will be determined by an arbitrator. This type of determination is not preferred due to various complexities involved. There is a significant risk that if the arbitrator is required to determine other terms and conditions, then that discretion will be exercised arbitrarily due to the lack of benchmarks or standards by which those terms and conditions can be determined.
10. Does the proposed model appropriately mitigate the risks associated with market intervention?	Woodside does not agree with the philosophy of Government or legislative intervention in a functioning market. The risks associated with market intervention relate primarily to uncertainty of when and how that intervention will take place, which has an immediate and lasting effect of deterring investment. The extent to which investment sentiment will return after any intervention will depend on the success of the model in achieving Government's 'emergency' objectives such that further intervention is unnecessary and certainty can be given to market participants that no further intervention is planned. The narrow application of cost-based pricing principles in a commodity-production context increases these risks. These risks would be mitigated if the pricing principles were amended in the manner we propose above, to reflect the market context and life cycle costs of supply. Even with these amendments, making gas suppliers and buyers subject to a negotiate-arbitrate regime risks slower negotiations, and greater volatility of price and uncertainty of supply in the market.

Western Australia (WA)

We would welcome confirmation that the Mandatory Code will not apply to the WA gas market. The WA gas market is fundamentally different to the East Coast, with differing infrastructure constraints and demand profiles. These differences between the geographical markets have been rightly acknowledged during the consultation on the recent price cap order and this consultation concerning the Mandatory Code. The Eastern gas region is described as the primary gas market in Australia, and other markets (such as WA) being physically or functionally separate, subject to different regulatory frameworks, and not experiencing the same supply and pricing issues. A code of conduct that may be suitable in the East Coast will not be suitable in WA and compliance may be costly, ineffective and deter investment.

Conclusion

As outlined in the Introduction and summary, Woodside is supportive of Government's objectives of promoting access to affordable and reliable domestic gas. Recognising that the Mandatory Code will involve a greater degree of directive regulation, we hope that our comments above are of assistance in addressing key aspects of the new approach.

Given the above feedback and commercial consequences of the Mandatory Code, we would appreciate confirmation by Treasury that industry will be provided a draft Code and reasonable pricing formula to review ahead of finalisation and implementation, to avoid any unintended consequences to existing or future supply.

Should you wish to discuss our feedback further, workshop key concepts or have further questions, please do not hesitate to contact Sally Giannopoulos, Woodside's Vice President Australian Gas.

Yours sincerely

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