Australia’s Energy Problems Are East Asia’s Energy Problems

by Geopolitical Futures - July 18, 2022

Much has been said about how badly the rise in global commodities has affected import-dependent economies – and rightly so. Yet some export-oriented countries are getting hammered too. Australia, for example, is one of the world’s largest coal and gas exporters but nonetheless faced domestic shortages of both amid an energy supply crisis. Naturally, this came as a shock to Australians accustomed to abundant resources and stable infrastructure, as did the blackout warnings and skyrocketing electricity prices just ahead of winter.

For now, the Australian government’s intervention in the domestic energy sector appears to have tamed the situation. But as supplies remain constrained and as winter temperatures set in, the government will have to weigh domestic consumption prices against economic recovery, the profits of energy companies and, as important, energy supplies to foreign buyers in East Asia whose economies may hang in the balance.

Bad Timing

Australia’s crisis owes mainly to long-term structural problems that have left its energy sector vulnerable to market volatility. Poor planning amid the politically fraught transition to renewables has left energy companies with an uncertain future. The grid currently relies on poorly maintained plants. Sufficient battery storage technology is not yet in place to support the move to a renewable grid, which still relies on a relatively small number of large, coal-fired plants. These large plants supply more than half the electricity to Australia’s East Coast. The grid simply could not cope with the heightened demand brought on by the early winter chills.

The timing couldn’t have been worse. Supply chains still reeling from the COVID-19 pandemic are under additional strain. High international energy prices encouraged additional exports but discouraged energy imports to bolster domestic supply. And this is to say nothing of Russia’s invasion of Ukraine, which sent shocks through global energy markets.

And though many of these factors are beyond Australia’s control, the current energy crisis – or at least the proximate cause of it – was self-inflicted. In an effort to control spiking prices, the Australian

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Energy Market Operator in mid-June imposed a cap of 300 Australian dollars ($200) per megawatt-hour on wholesale electricity prices as part of a legislative effort to protect consumers from high prices. This was well below the AU$400 producers say was their break-even price. The result was a 20-percent reduction in generation capacity for the East Coast on top of standard outages already affecting a quarter of coal-fired stations.

The most dramatic of AEMO's mitigation efforts was the suspension of eastern Australia's energy market. While this has previously occurred in the states of South Australia and Tasmania, it was unprecedented on such a wide scale. Normally, generators offer supply for sale on an open market for purchase by electricity retailers. The market takeover allowed the operator to direct all available capacity back online and determine pricing. The suspension was lifted on June 24 after four gigawatts, or about 20 percent of the grid's average demand, came back online.

High energy prices threaten Australia's economic recovery, increasing the cost of goods as industry overheads grow and contributing to inflation as prices rise. Interest rates in Australia have been increasing to combat inflation, and the risk of recession remains high. Energy prices also endanger thousands of manufacturing jobs, further disrupting the "gas-fired recovery" on which the Australian government had pinned its hopes of economic growth in the wake of the pandemic.

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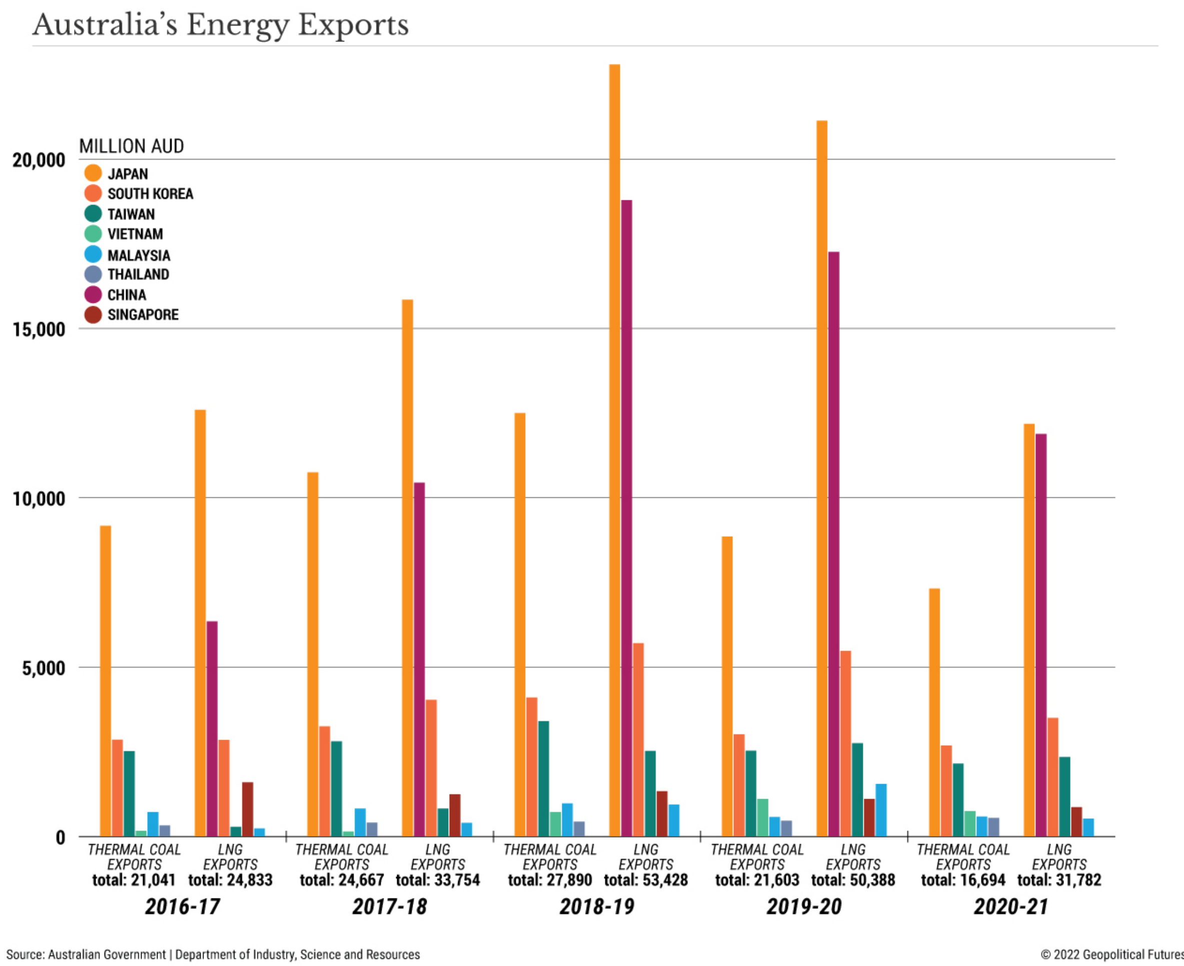

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For now, the Australian government is betting that continued revenue from hydrocarbon exports will ultimately offset any domestic economic setbacks incurred by higher domestic prices. The country now exports around three-quarters of both its coal and gas production, accounting for 3 percent of its gross domestic product. These export levels are likely to be maintained despite widespread speculation that the Australian Domestic Gas Security Mechanism – designed to address genuine supply shortages, not artificial ones such as the current crisis, and which would not come into effect until January 2023 – would be triggered. Though the rules that govern this mechanism could be rewritten, the federal government is unlikely to sacrifice a major aspect of the Australian export economy to spare consumers high prices. Gas reservation would necessarily involve breaking long-term contracts that cover up to 90 percent of Australia's gas market. This would incur penalties and risk alienating trade partners and companies' bottom lines at a time much of the world is willing to pay a premium. The fact is that the threat of export reservation is more significant than the actual

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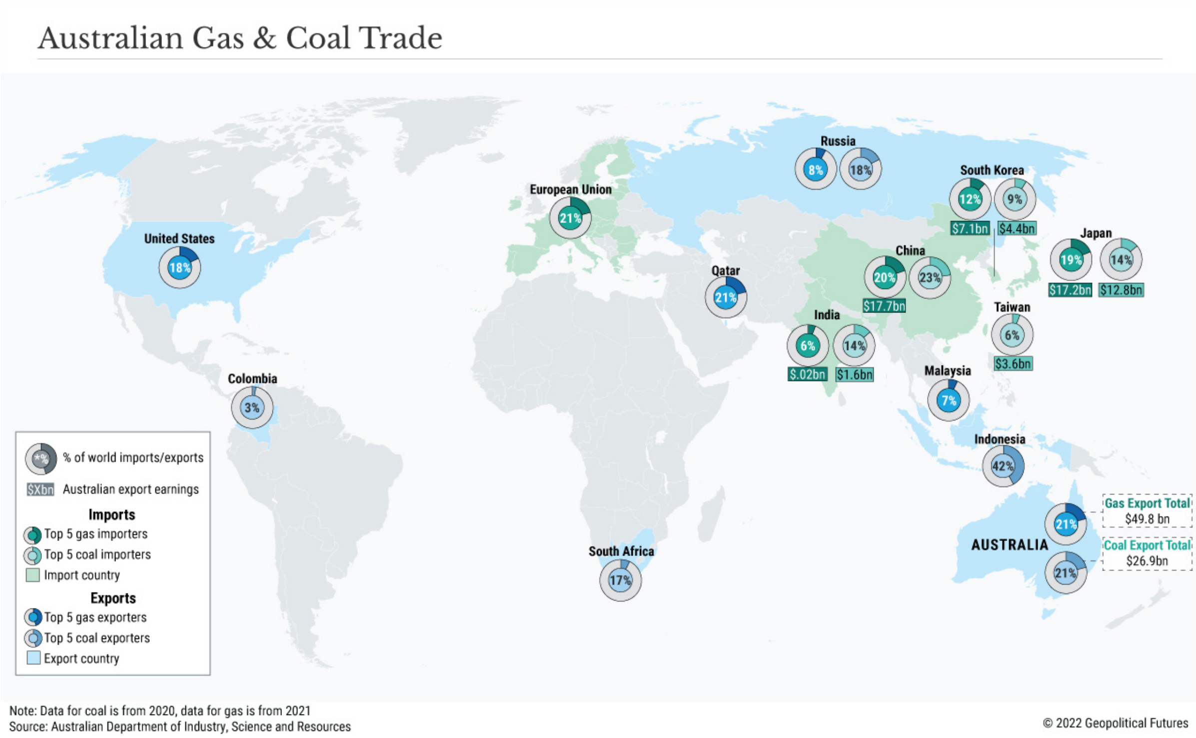
effect it would have on exports. Allusions to gas reservation or market takeovers have previously been used by the government to keep suppliers and producers in line and prices in check.



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On Edge

Even so, the fact that reservation is on the table at all will put Australia's trade partners on edge. Australia is the world's largest exporter of liquified natural gas, shipping $40 billion of it in 2021. The vast majority of Australian LNG is shipped to just three countries: China, Japan and South Korea, the world's three largest gas importers and the largest economies in East Asia. Australia is easily the largest gas supplier to China and Japan, accounting for 40 percent of gas imports in both and about a third of South Korea's. Australia also provides the majority of Japan, South Korea and Taiwan's coal imports. (China was Australia's largest customer until an informal ban took place in 2020, driving a large increase in exports to India in particular, with Australia supplying a fifth of India's imports by early 2021. While the ban has not yet been lifted, China's need for energy supplies has forced it to reconsider. If it resumes imports, it would greatly increase demand for Australian coal and create potential sourcing problems for India, which is also in the midst of a major energy crunch.)

Importantly, Japan, South Korea and China have their own price-induced energy crunches that have

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weighed down their economies. Japan imports nearly all its energy, forcing the government to consider restarting dormant nuclear power plants. It is also facing an intense heatwave, causing power rationing and outages in economically important areas in and around Tokyo. Strikes over high energy prices in Japan and South Korea have been going on for weeks, and they would almost certainly continue if supply declines. South Korea, which also imports the vast majority of its energy resources, saw record-high electricity demand last month while strikes and supply chain issues strained generators. China suffered a power crisis of its own in 2021, substantially hurting its manufacturing sector. Electricity demand in northern China has reached record highs since mid-June, and several provinces are preparing for the risk of inadequate power supply this summer.

Considering the international energy landscape, buyers are watching Australia's energy crisis with great concern. Any disruption in supply from a solid supplier like Australia would severely compromise their economies, forcing their governments to find alternative supplies in a tight, expensive market.

Notably, the United States has a vested interest in Australia maintaining a steady flow of energy exports because Australia is a critical ally in managing East Asian relations. While this is most often thought of in terms of security cooperation, there is also an economic dimension. The two work very closely on regional maritime security and commercial stability. The risk of regional economic disruption as a result of Australia's domestic energy issues would create a host of economic problems for East Asian countries that would bring on a new set of security challenges, directly or indirectly, to the U.S. and its allies at a time when Washington already has its hands full dealing with Europe, Russia and China.

None of this seems likely in the short term. But uncertainty surrounding high prices isn't something the rest of the world can ignore. Reducing exports may be a last resort, but that's no comfort to Australia's buyers. The major Asian economies will need to consider their energy options to hedge against the potentially disastrous impact of losing a major supplier in such a febrile global environment.

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