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Mr John Pierce
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Dear Mr Pierce

AER Submission to Victorian Declared Wholesale Gas Market Consultation Papers

We welcome the consultation on a package of proposed rule changes designed to make incremental improvements to the operation of the Victorian Declared Wholesale Gas Market (DWGM).

We note that the rule change requests from the Victorian Minister for Energy, Environment and Climate Change are based on the recommendations the Australian Energy Market Commission (AEMC) made in its *Review of the Victorian declared wholesale gas market* final report in June 2017 (2017 Report). The AER expressed support for incremental reforms in these areas in its response to the preliminary *Assessment of Alternative Market Designs* released by the AEMC in March 2017, as a precursor to further consultation on some of the long-term recommendations from the draft final report.

We remain supportive of the intent of the proposed rule changes in making incremental improvements to the operation of the DWGM in pursuit of the national gas objective (NGO) and as a further step towards the COAG Energy Council's Vision for Australia's future gas market. Our comments below bring together some information that we expect will be useful background to the consultation for each of the three issues raised. It will be important that the consultation process elicits views from stakeholders on the expected benefits and costs of the proposed changes, particularly given that changes to market conditions may have led to changes in the expected costs and benefits since the 2017 Report. In addition, and as highlighted in the individual papers, an important part of the consultation will also involve considering the interactions between the various rule change proposals.

We look forward to further involvement with the AEMC and stakeholders as the consultation process continues. In recognition that these proposed rule changes are an initial set of reforms designed to address issues identified by the AEMC in its review of the DWGM, we propose to further develop our market trend data on the DWGM to assist in evaluating trends in the market pre and post rule change. This work will build on our 2018 liquidity metrics

reporting work.¹ We anticipate this will assist the AEMC and policy makers in evaluating the effectiveness of these market reforms and in assessing the need for future rule changes.

DWGM Forward Trading Market

This proposed rule change addresses the AEMC's finding in its 2017 Report that DWGM market participants had limited options for managing spot price risk. The long-term gas supply agreements (GSAs) that users enter into with suppliers have become less flexible, and secondary trades between market participants involve high transaction costs. These high transaction costs arise as consequences of the time-intensive search and negotiation process and the potential counterparty risk involved in negotiating bilateral contracts. At the time of this report there was virtually no trading in gas futures products on the ASX. This has since changed, as discussed below.

We support the objective of improving the ability of market participants to manage their spot price risk. Improved ability to manage price risk may improve future investment decisions, encourage new entrants and boost competition, reduce participation costs across east coast trading markets and place downward pressure on the costs of providing and using gas.

The consultation process will need to consider market participants' perspectives on how the benefits of a forward trading market compare to the costs involved in setting up the new market – particularly given evolution in ASX Victorian gas futures contract activity since the 2017 Report. We also encourage the AEMC to consider the interaction of the ASX Victorian gas futures market with the proposed DWGM forward trading market, including:

- the costs and benefits of having similar or differentiated products on both markets – particularly longer-dated forward or futures products that appear to have similar risk management characteristics; and
- how trading and liquidity in the existing ASX futures market are likely to be affected by the introduction of the proposed forward trading market.

If the feedback confirms the benefits of a forward trading market outweigh the costs, the AER supports the design principles of integrating the forward trading platform into the DWGM and of having similar products and market characteristics across both the forward trading market and existing gas supply hubs (GSHs). In our view, this should minimise duplication and the costs of implementation and facilitate comparison and trade with other gas markets.

Evaluating the level of trade in the ASX futures product

As the AEMC identified in its consultation paper, there was virtually no trading in ASX gas futures products prior to 2018. In our market liaison, gas market participants have cited both the complexity of pricing in the Victorian market and inconsistent or inadequate publicly available information about upcoming infrastructure outages as explanations for why the ASX Victorian gas futures contracts have not been more widely traded.²

From the beginning of 2018, ASX Victorian gas futures contracts began to trade, with the volume of trading increasing over the year. Currently, the open interest in ASX Victorian gas futures contracts for the second, third and fourth quarters of 2019 ranges between 100 and 165 contracts, equivalent to 10-16.5 TJ of gas per day. Increased trading in the Victorian gas futures market could indicate that market participants are becoming increasingly comfortable using futures product as a hedging tool.

¹ www.aer.gov.au/communication/aer-publishes-more-metrics-to-enhance-market-transparency

² The issue of price complexity is addressed in the DWGM Simpler Wholesale Price rule change proposal.

However, it is important to note that current trading in ASX Victorian gas futures contracts remains low overall when compared to more established futures markets like the national electricity market.

- In the first three months of 2019, the volume of ASX Victorian gas futures contracts traded was around 200.³
- In comparison, the volume of Victorian ASX electricity futures contracts traded over the same period was around 18 500.⁴

These trading volumes may indicate that DWGM participants continue to see the current ASX futures market product as an insufficient overall hedge to Victorian gas market price risk (both spot price risk and ancillary payment risk). The AEMC should consider any evidence from market participants on usage or otherwise of the ASX product and any reasons for not using the product, for example a preference to contract gas storage that can be accessed when spot prices are high as a physical hedge. We do not have information on who is trading the ASX product – such as the split between physical and financial players – however the views of both would assist to understand how the product is being used.⁵

DWGM Simpler Wholesale Price

This rule change proposal incorporates proposals from both the Victorian Minister and from AEMO on behalf of EnergyAustralia.

The Victorian Minister's rule change proposal to spread congestion uplift payments among market participants aims to address a number of identified shortcomings with the current congestion uplift methodology. The identified shortcomings include:

- the complexity of the methodology
- the possible failure of the existing methodology to allocate costs to causers
- the challenges that the methodology presents for risk management or trade, and
- that the evolution of the market means these issues are likely to increase over time.

While the AEMC's 2017 Review recommended including both common and congestion uplift in the market price, subsequent analysis by AEMO and the Victorian Government has concluded that this proposal would be highly complex to implement and at odds with reforming the DWGM in a timely fashion. The Victorian Government has also raised the possibility of pursuing alternative options such as changes to the current methodology to make it more cost-reflective or implementing a directional flow-point constraint mechanism.

AEMO's rule proposal (initially proposed by Energy Australia) aims to improve outcomes for the market where a system constraint physically limits scheduled withdrawals from the declared transmission system by internalising these withdrawal constraints in the pricing schedule.

We support the initiative of investigating whether the DWGM pricing methodology can be improved. In particular, we note that a previous investigation into high levels of ancillary

³ Figures from ASX monthly trading report for March 2019. Accessed on 18 April 2019 from www.asx.com.au/prices/daily_monthly_reports.htm

⁴ Figures sourced as above.

⁵ AER staff have heard in correspondence with sector participants that financial participants may be speculating on Victorian gas and electricity prices concurrently through trading ASX futures, although again we are unsure of the relative use of the product by participants with physical exposure to Victorian gas market prices versus pure financial participants.

payments in the DWGM on 1 October 2016 highlighted concerns about the operation of the pricing methodology. We also note that a simplified pricing methodology may assist the development of markets for risk management products (such as futures or forward markets) to the extent that participants are able to effectively mitigate a greater proportion of their total market price risk.

In addition, we recommend that consideration of this rule-change proposal should also take into account both:

- the potential for a continuation of the recent trend for constraints to be triggered by maintenance or outage, and
- the possibility that constraints relating to high levels of demand could also reoccur as the energy market continues to evolve.

The consultation includes a variety of proposals to improve the methodology. In our view, it is unlikely that any one methodology would be able to deliver both a simpler methodology, greater predictability, more cost-reflective pricing, and a single price to facilitate hedging. For these reasons, the views of market participants will be key to assessing the trade-offs between the various options.

Uplift payments complex, and costly for participants without AMDQ

Through our market liaison, we have heard that the uplift payments in the Victorian market can be a significant financial burden on participants without AMDQ credits. This may disproportionately affect smaller players and may act as a disincentive to new players considering entering the market.

In our role monitoring the performance of wholesale markets, we are responsible for investigating significant market events – one trigger for an investigation is when ancillary payments exceed \$250,000 in one day. As discussed in the background paper, uplift payments are allocated by AEMO to recover the ancillary payments made to market participants when their more expensive gas offer is required to be constrained on as a result of congestion.

In particular, we investigated events on 1 October 2016 when ancillary payments in the DWGM exceeded \$250,000. In our report summarising the investigation, we noted that market participants did not understand how the uplift payments levied on them were allocated.⁶ In particular, some market participants felt that they were disproportionately penalised relative to their actions on the day. Smaller players who did not have authorised maximum daily quantity (AMDQ) credits said they were particularly disadvantaged, as they were deemed by AEMO to be contributing to the constraint but did not have AMDQ credits to be able to nominate at alternative points in the Victorian system.

These concerns underline the importance of investigating improvements to the DWGM pricing methodology and/or adjustments to the AMDQ regime. To the extent that the methodology that would best achieve the NGO would take some time to implement, there may be opportunities to look for incremental improvements to address some of the existing concerns.

Infrastructure development and constraints

The incidence of constraints has declined noticeably over recent years, owing to the expansion of the South West pipeline and the Victoria-NSW interconnect. In addition, further expansions of the south west pipeline (WORM project) will occur in 2021 to accommodate

⁶ AER, *Significant price variation report – Victorian gas wholesale market – Longford facility outage 1 October 2016*, 21 December 2016.

expected future requirements.⁷ The consultation paper notes that, partly as a result of physical investment, congestion in recent years has been more likely to be caused by maintenance or outage rather than constraints due to high levels of demand.

We suggest caution in assuming that either of the trends of decreasing constraints or of constraints being dominated by maintenance- or outage-driven events will continue. We have seen movements of gas become increasingly erratic due to unpredictable demand from gas powered generators, particularly in Victoria and South Australia. AEMO's latest Gas Statement of Opportunities and Victorian Gas Planning Report highlight the uncertain but potentially high demand for gas to generate electricity.^{8,9} Accordingly, it is important that an improved methodology can properly accommodate constraints being triggered by high demand as well as maintenance or outages restricting supply.

For example, maintaining a pricing regime that provides incentives to participants to actively manage the occurrence of demand-driven constraints may provide an important signal to drive critical investment that could be required to satisfy Victorian demand. This is particularly the case in an environment in which Queensland is likely to be supplying higher volumes of gas to Victoria given the forecast reduction in supply from Gippsland basin. AEMO's 2019 Gas Statement of Opportunities suggests that shortages could occur in 2024 without upgrades to infrastructure.

We support the consultation process considering the possibility that the source of constraints may change over time as the market evolves. This will help to make the proposed solution more robust to future developments.

DWGM Improvement to AMDQ Regime

This proposed rule change aims to improve the operation of authorised maximum daily quantity (AMDQ) in the DWGM by separating entry and exit rights, introducing an electronic trading platform for secondary trading of AMDQ rights and benefits, and making AMDQ available for a range of time periods.

We support an investigation of the ways in which AMDQ can be made more usable. In particular, we note that the existing AMDQ regime could advantage incumbent players over newer entrants given periodic auctions and limited secondary market trading. Difficulties in accessing AMDQ may be restricting newer players' ability to compete by restricting their ability to inject or withdraw gas across the DWGM.

Further, we support the introduction of an exchange to improve secondary trading of AMDQ rights and benefits to assist in ensuring that they are held by those who value them most. We note that it may be worth considering whether the recent capacity trading reforms could provide any guidance on creating incentives to trade where rights or benefits will otherwise go unused.

We also welcome consultation on other reforms that could make AMDQ simpler to understand and use, better tailored to market participants' needs and/or more conducive to encouraging productive investment and that are consistent with the NGO. Given the complexity of the AMDQ regime it will be important that the consultation process effectively identifies and weighs the costs and benefits of the various proposals.

⁷ AEMO, *Victorian Gas Planning Report*, March 2019, page 8.

⁸ AEMO, *Gas Statement of Opportunities*, March 2019.

⁹ AEMO, *Victorian Gas Planning Report*, March 2019.

Monitoring the Success of Reforms

The proposed rule changes represent an initial set of reforms designed to address issues identified by the AEMC in its review of the DWGM. The 2017 Report recommended both a set of short-term recommendations aligned with the proposed rule changes, as well as a longer-term recommendation for fundamental reforms to the DWGM to align it with the AEMC's identified target model. The AEMC recommended that its biennial report in growth in liquidity in wholesale gas and pipeline capacity trading markets would be an appropriate vehicle to assess:

- *the success of the short-term recommendations,*
- *the general development of the southern market, and*
- *whether more substantial reform towards the target model is appropriate.*¹⁰

To support the AEMC in carrying out this recommendation, we propose to further develop our market trend data on the DWGM to assist in evaluating trends in the market pre and post rule change. This work will build on our 2018 liquidity metrics reporting work.¹¹ We anticipate this will assist the AEMC and policy makers in evaluating the effectiveness of these market reforms in assessing the need for future rule changes.

We thank the AEMC for the opportunity to submit on this process and look forward to ongoing involvement in these processes. If you have any questions about our submission, please feel free to contact Kevin Fincham (07 3835 4677).

Yours sincerely,



Paula Conboy
Chair
Australian Energy Regulator

¹⁰ AEMC, *Review of the Victorian Declared Wholesale Gas Market*, final report, June 2017, page iii.

¹¹ www.aer.gov.au/communication/aer-publishes-more-metrics-to-enhance-market-transparency