"Designing a resilient wholesale gas market"

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Introduction

Thank you.

And good afternoon ladies and gentlemen.

Today, we've heard a number of presentations on preparing and responding to changing gas market dynamics including; the role of gas in the domestic energy mix and the policy context in transitioning to a low-carbon economy. All of these perspectives, and the many others that will follow this afternoon and tomorrow, provide valuable insights into the challenges and complexity of the structural shifts underway and 'pain points' for both gas producers and consumers.

An important aspect of the work the AEMC has been asked to do in laying out a gas market development path towards the COAG Energy Council's vision, is that it is not dependent on being in some part of the commodity cycle, or the economic cycle, or for that matter, the specific economic challenges of the day.

<u>It's about something far more fundamental.</u>

1. That consumers can see whether the price they are being offered for gas is a reasonable market price, and

2. That the gas that is available goes to where it is valued most, thereby making a greater contribution to the value of Australia's economic output.

For a range of reasons, some of which have been canvassed during today's discussions, we only have a relatively small window of opportunity to adjust our domestic gas market arrangements towards that vision - and make lasting change.

An opportunity to take the reform steps necessary to create a resilient wholesale gas market, one that is transparent, flexible and can adapt to whatever the future may bring. A wholesale gas market that is efficient, secure and reliable for the long-term interests of consumers.

It will take the commitment of everyone involved in the sector, and some give and take, to get us there.

Energy Council Vision for the creation of a liquid wholesale gas market

Back in late 2014, COAG's Energy Council decided on a destination and then asked the AEMC to draw the roadmap to get there.

It published its vision for the creation of a liquid wholesale gas market:

- one that provides market signals for new investment,
- where trade is focused at a point that best serves the needs of participants,
- where an efficient reference price is established to allow for the development of risk management tools,
- and producers, consumers, and trading markets are connected to infrastructure that enables participants the opportunity to readily trade between locations and arbitrage trading opportunities'.

The Victorian government also asked us to look specifically at changes to the Victorian wholesale market to improve price and investment signals so that benefits in trading, risk allocation and lower transaction costs could flow through to consumers here. Our recommendations for Victoria form a significant part of reforms to east coast markets.

In December, we published our draft reports and recommendations to deliver the Energy Council's Vision. These recommendations drew on substantial and valuable contributions from a wide range of stakeholders and we are looking for further very specific feedback with 2 more discussion papers released last week.

One focuses on the next layer of detail for a new Southern Hub gas trading market in Victoria with an entry-exit system for capacity allocation. The other concerns for recommendations reform of the contract carriage arrangements for gas transportation on the east coast of Australia. The closing date for submissions is March 29 and I encourage you to continue to help shape our thinking.

Our final report to COAG is due in May. In the event that the roadmap is accepted by the Energy Council, the focus would then shift to implementing the recommendations endorsed by it. In reality, there would be several staged phases to guide the development of the market and regulatory arrangements over a number of years.

That's the scope of the task and the commitment required.

So, what does the roadmap for future market development look like?

Key elements of the roadmap for future market development

We have recommended a package of reforms in 3 areas that mutually reinforce each other.

1. Changes to wholesale gas trading markets will concentrate trading at 2 points: the Northern Hub at Wallumbilla in Queensland and the Southern Hub in Victoria, to concentrate trading liquidity at key points of demand and supply on the East Coast. These will be voluntary markets that deliver a clean wholesale reference price, and which, over time provides a meaningful tool for managing a gas portfolio.

2. Changes in pipeline access arrangements that will improve the access to pipeline capacity by introducing market mechanisms and trading platforms, and

3. Better provision of information with an expanded Bulletin Board.

A liquid wholesale gas market, with many parties buying and selling gas establishes an efficient and transparent reference price for gas. It will decrease barriers to entry, increase competition and promote the efficient allocation of gas to where it's most valued. It will also act as a credible alternative source of supply to long-term bilateral contracts and consumers will know if the price they are being offered for gas reflects underlying demand and supply, and a reasonable market price.

The reform package is designed to allow the flow of available gas more freely throughout the interconnected system. We recognise that many of you are concerned about the impact of supply from gas fields and we share those concerns. So while issues relating to gas production and land use planning or levels of competition in the production and pipeline sector largely fall outside the AEMC's remit, we are, however mindful of their impact on consumers and are consulting with others, in particular the ACCC, so the context for our proposals is understood.

The need for reform: 2 major drawbacks of the current Victorian situation

It is, of course, the changing demand and supply dynamics that are driving the rationale for reform of the way gas is bought and sold. I won't spend too much time on this because it's been discussed earlier today, but the structural changes ushered in by LNG exports, with impacts on patterns of gas flows and wholesale gas prices, is a fundamental and irreversible change to the Australian market. We can expect to see more volatility in the market generated by the LNG loads and the coal seam gas fields that supply them.

The best outcome would see gas transported to those users who value it most. But to do this, we need the right kind of pipeline transportation arrangements and wholesale trading markets in place to allow the sort of short-term trading response that would be required.

Reform roadmap: a staged approach

So where to from here?

To achieve the Energy Council's vision of a liquid wholesale gas market, we need to create a self-reinforcing loop that encourages both buyers and sellers to participate in facilitated markets. More participants and greater traded volumes lead to more meaningful pricing signals, reflective of underlying demand and supply conditions, giving sellers and buyers confidence that the market can support their needs. As trading volumes increase, financial risk management tools can be developed, further strengthening confidence in the market.

We want market participants driving investment decisions and bearing the associated risks. To do this wholesale trading markets need to be accessible, easy and low cost to use and be supported by information that allows efficient decision making.

The transfer of ownership and pricing of gas takes place at defined locations on a gas network called hubs, which can be physical or virtual.

The problem with multiple physical hubs, and therefore the need to source pipeline capacity to transport gas to and from hub locations, is that not all participants are able to access all physical points on the network. It can also have a negative impact on trading liquidity and hence not provide meaningful price information associated with a liquid 'market'. We have heard from stakeholders that this is currently an issue with accessing the physical hub at Wallumbilla. They would like to trade there but cannot get access to pipeline capacity to get their gas to or from the hub.

On the other hand, virtual hubs allow for title transfer of gas anywhere within the definition of the hub, and hence provide participants with greater trading flexibility and promote liquidity. The current Victorian market design is an example of a virtual hub. These hubs, which can account for the entire gas transmission of a country in Europe, need a system for allocating transmission capacity into and out of the hub area and can be more complex to balance.

In the Australian context we can see benefits in both physical and virtual hubs and so have tailored our recommendations to the characteristics of the existing markets. Our roadmap for improvements to the Victorian market is centred on augmenting the existing market arrangement to create a virtual 'Southern Hub' for trading gas. This involves transitioning from the compulsory trading model today where over 80% of the gas flowing through the system is simply participants selling gas to themselves, to a voluntary, exchange-based trading model more similar to that in place in Queensland's Wallumbilla market.

In this type of market, only those participants looking to buy and sell gas are required to use the exchange – posting bids and offers to buy and sell gas over various time horizons depending on their requirements. This would allow the publication of a 'market price' on the exchange that is not affected by any ex-post deviations. Over time, as confidence in the market increases, this exchange price can be used as a reference price in bilateral contracts and can also form the basis of hedge instruments.

To support this new form of trading, we propose to transition the market carriage model and associated limited pipeline transportation rights, to a system of entry and exit rights for capacity allocation. This type of capacity allocation mechanism helps to provide better signals for investment in a 'virtual market' like the DTS because market participants bid for firm transportation capacity rights, and have to pay for that capacity, they also bear the risk of any over-investment. Price signals are improved because the price of capacity will rise with demand as signalled through auctions used to allocate capacity at each entry and exit point.

Wholesale commodity trading of gas is already happening at Wallumbilla in Queensland and we believe it is the best location for the development of a liquid northern trading hub, given the intersection there of many pipelines connecting many producers, users and facilities like storage. Although the northern hub would initially be a physical hub, trading arrangements would be harmonised across the two markets laying the foundations for a virtual hub at a later date.

I want to touch on the Short Term Trading Markets which have provided an effective and competitive gas balancing service and have contributed to price transparency on the east coast. These markets provide flexibility to new entrant retailers and large industrial users of gas who can choose to buy some or all of their gas requirements through the market instead of directly from producers or retailers. This lowers barriers to entry and promotes competition, creating benefits for consumers.

Over time as the Northern and Southern Hubs and in- pipeline capacity trading develops, we would expect the Short Term Trading Markets to purely support transparent and competitive balancing. This will reduce transaction costs for participants who have to engage with these markets on a daily basis, while still preserving the flexibility the Short Term Trading Markets have provided in recent times.

Encouraging growth in liquidity and a meaningful reference price at the Northern and Southern hubs, along with reforms to pipeline access and information provision, will provide participants with greater flexibility for buying and selling gas. Because of this, there will not be a strong requirement to trade at the demand centres and the benefits of retaining the STTM hubs as independent pricing points is likely to be outweighed by the costs to participants.

A key part of the transition away from the use of STTMs is therefore improvements in pipeline access arrangements. Indeed all the wholesale market changes will be undermined if the reforms to the pipelines are not implemented successfully.

We suggested three main reforms to improve the transparency of pipeline arrangements and lower the search and transaction costs associated with trading pipeline capacity. Stakeholders had told us that capacity trading in the shorter term, that is less than six months, was difficult and high cost – often involving contractual negotiations that would negate the commercial opportunity of accessing the capacity.

1. The first reform is to establish an auction mechanism for contracted but un-nominated capacity – commonly called as-available capacity. This is capacity for which shippers have already paid the pipeline operator, but which reverts to the pipeline operator if not used by the shipper. We are suggesting that a market-based mechanism should be introduced to allow this capacity to be offered up to whoever values it the most – but with a reserve price to be established independently through a methodology approved by the Australian Energy Regulator (AER).

2. The second area of reform is the development of standardised capacity contracts and products that can be traded through a compulsory trading platform. It would not be compulsory to use the platform for the transaction itself but it will be a requirement that information about the capacity trade is placed on the platform. Standardised products and a place to trade them, should greatly reduce search and transaction costs, and price transparency of historical trades should give the market more confidence that they are getting a 'fair' price for that capacity.

3. Finally, continuing the theme of transparency, we are suggesting that more information be published on the price at which primary capacity is sold.

While these changes to pipeline access arrangements do represent significant changes for the Australian market, they are very much in keeping with requirements on pipeline operators and shippers in other countries who have recognised the key role that pipelines play in supporting a liquid and competitive wholesale gas market.

I mentioned earlier that we had just released a discussion paper that provides further detail on these reforms including options for auction design, key elements of capacity contracts that would require standardisation etc.

The last area of reform in our package of recommendations is to enhance the information provided to the market.

Market participants must have easy access to the information they need to make informed decisions about the prices they expect to see from a competitive market. In gas markets, this means not just one specific data point but a range of information about production and consumption levels, transportation flows and investment levels in both the short and long-term. We know there are information gaps across the sector that affect the price discovery process and the way that gas and other resources are allocated. Trading and other decisions must currently be made on the basis of incomplete, inaccurate and/or asymmetric information.

We are recommending that the coverage of the Bulletin Board be expanded so that a wider range of information is provided and the reporting and compliance frameworks strengthened. Specifically we are looking to include information on reserves, large user demand and hub services. We are well advanced in this work and should be in a position to make specific recommendations for implementation that are able to be progressed immediately, in our Final Report in May.

Benefits of reform

What we're really talking about with this package of reforms is deriving economic benefit from the interconnectedness of the system.

For Victoria, the benefit of reform means gas could be traded anywhere in the system, leveraging easy to use markets which minimise transaction costs, which should be reflected in end prices to consumers.

For the East Coast of Australia as a whole, the benefit of reform is a liquid wholesale gas market that is resilient and able to trade and mitigate the effects of increased volatility and shocks to the sector.

For Australia, the benefit of reform is in overcoming the challenges of a small number of market participants dispersed over a very large geographic area. It means getting the *mechanisms* right so that we can respond to any changes in supply across the country, whether LNG gas exports are high one month, or low with the supply pushed south, the next.

What we want is that gas consumers know that the price they pay for gas is the reasonable market price. They may not necessarily like the price they are paying, but at least they know that the price is being driven by market fundamentals, and is the same or similar to that being paid by the next person.

Staying the course

It goes without saying that any major policy implementation is difficult. The National Electricity Market didn't happen overnight. And it's easy to forget just how much has changed over the past 30 years of energy market reform.

Experience tells us that major reforms with long-lasting benefits need to be implemented carefully and take time. The detail matters. The challenge is maintaining the commitment, staying the course for as long as it takes to land economic structural reform. Setting policy objectives is of course, the role of governments. It was their vision for the creation of a liquid wholesale gas market. The AEMC's role lies with the mechanisms used to achieve the reform agenda set by COAG's Energy Council, and seeing it done in a way that supports the efficient operation of the energy market and the long-term interests of consumers.

It will take the efforts of all of us to do it; it will take time, and some give and take.

I invite you to join us on this journey of future development of the east coast gas market.

Thank you

~ENDS~

Check against delivery