

# **“Designing a resilient gas market, not just for our times but for the future”**

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## **Introduction**

Thank you.

And good afternoon ladies and gentlemen.

It's a pleasure to be here today and to see so many who have a stake in the future of our energy markets.

Whether you believe it's more a curse or a blessing, we, in the energy game, are living in interesting times. A time of enormous upside potential: positioned as we are, on the doorstep of Asia, as the world transitions to a low carbon economy. But it's also a time of uncertainty, given the structural changes to domestic demand and supply dynamics, increasingly driven by the LNG export industry, and changes to prices driven by international influences.

To appreciate just how rarely these opportunities arise, we'd have to go back to the late 1960s with the discovery of oil and gas reserves in Bass Strait, or perhaps back further to the 1950s when Hancock stumbled upon iron ore in the Pilbara, or maybe even further back to the 1850s gold rush. What I'm saying about the situation we find ourselves in is less about the size of the opportunity, and more about its frequency - these opportunities don't come along very often in our lifetimes.

While we can marvel at the scale of this – a multi-billion dollar East Coast domestic and natural gas export market, we should also recognise the sobering reality that we only have a relatively small window of opportunity to adjust our domestic gas market arrangements to this major structural shift.

A window of opportunity to make lasting change.

To develop a resilient wholesale gas market - not just for our times, but for the future.

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.

And it will take the commitment of everyone in the sector to get the best out of this opportunity.

In this endeavour, the AEMC's work is being guided by the COAG Energy Council's vision for the creation of a liquid wholesale gas market, which they published in late 2014:

- 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 Energy Council decided on a destination, and asked the AEMC to draw the roadmap to get there, given the new LNG industry market dynamic. 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.

In December, we published our draft reports that outlined proposals for delivering the Energy Council's Vision. Submissions on these draft reports closed last Friday and we were pleased to receive substantial and valuable contributions from a wide range of people. There was also strong participation across a series of forums where many views were openly shared.

Issues relating to gas production or levels of competition in the production and pipeline sector largely fall outside our 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.

Our final report to COAG is due in May. In the event that the roadmap is accepted by the Council, the focus would then shift to implementing those recommendations endorsed by the Energy Council. 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.

The gas market development path we have laid out 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.

It's about something far more fundamental.

- 1) That consumers can see whether the price they are being offered for gas is a reasonable market price, and
- 2) That it goes to where it is valued most, thereby making a greater contribution to the value of Australia's economic output.

So, what does the roadmap look like?

## **Two major drawbacks of current Victorian situation**

Let's start with the current situation here in Victoria. We see two main issues with the current system: the inability to manage price and volume risks, and a lack of market-driven investment in the pipeline system.

Since it was established in 1999, the Declared Wholesale Gas Market (DWGM) in Victoria has largely been effective in supporting retail competition and encouraging a diversity of supply and upstream competition.

But we are now at an inflection point - as we've seen, Victoria is not immune to the structural changes ushered in by LNG exports with impacts on patterns of gas flows and wholesale gas prices. We can expect to see more volatility in the market generated by these large loads and the coal seam gas fields that supply them. There will be times when LNG export plants are unable to absorb supply. Some of these events will be known like planned maintenance outages and can be managed, but lots of events cannot be planned for - lots of things all have to go right for an LNG vessel to be filled and leave port right on schedule. If an LNG ship is delayed, due to bad weather, for example, large volumes of gas will need to go somewhere. The best outcome is for the domestic market to see the benefits of this supply by having that gas transported to Victoria or whichever users value it the most. But to do that we have to have 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.

These developments, and the volatility they are likely to bring, also mean it's critical that the Victorian gas market design has the flexibility to accommodate structural changes in demand and supply dynamics so that participants can actively manage the price and volume risks they face. However, the preconditions necessary for the development of financial risk management products do not exist in the Victorian Declared Wholesale Gas Market. This has the potential to deter market entry and result in consumers paying more than is necessary.

The prices in the Victorian gas market largely reflect short-term imbalance positions of participants and the ex ante pricing developed before the actual gas day is subject to uplift and deviation payments. The difference between the ex ante price and the ex post price means that it's unlikely financial trading can develop in Victoria with the current market design, meaning that market participants must hedge these risks through physical trades outside the market. This may not have mattered much in a stable market but it is increasingly costly and difficult in a more dynamic market.

To date investment in the Victorian Declared Transmission System and other pipelines outside the DTS has seen pipeline transportation evolve into an interconnected network, physically linking Victoria with the rest of the East Coast. This interconnectedness makes it increasingly important that there is a meaningful price signal of underlying supply and demand conditions to promote efficient decisions regarding flows of gas to and from Victoria and further investment in the future.

This leads me to the second area that we were asked to address - the lack of mechanisms for market-driven investment in the Victorian pipeline system. What we see is investment occurring mainly through the regulatory process where costs are recovered from consumers.

Currently, there is little incentive for shippers to underwrite investments in the pipeline because they do not have exclusive rights to use any extension or expansion in the DTS. This means we have a 'free rider' problem because all shippers would benefit from a capacity expansion, whether they fund it or not. It also means that if investment does occur on the back of shippers' demand, but that demand does not materialise, it is consumers who end up bearing the cost of that over-investment. The need for a more dynamic market response means that any impediments to market-led investment will become increasingly costly to Victorian gas users.

## **Possible solutions**

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 of gas 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.

Our roadmap for improvements to the Victorian market are centred around augmenting the existing market arrangement to create a '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 has been utilised throughout Europe and helps to provide better signals for investment in a 'virtual market' like the DTS. It also helps pool market participants because you only require capacity to enter and/or exit gas from the market rather than point to point capacity rights. Furthermore, because market participants bid for firm transportation capacity rights, and have to pay for that capacity, they 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.

We've also made recommendations in the broader East Coast review that should make it easier to move gas into and out of the Victorian market by improving access to contracted but unutilised pipeline capacity.

Let me turn now to an overview of the benefits that can be achieved by making these changes.

## **Benefits of reform**

What we're really talking about is deriving economic benefit for Victoria 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 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.

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 price is being driven by market fundamentals, and is the same (or similar) to that being paid by the next person. By progressively winding back barriers to the flow of gas, we can ensure it goes to where it is valued most.

## **Staying the course**

So there are potentially large benefits from change but 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 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.

## **Conclusion**

Let me finish by saying, the opportunity to drive successful development of a liquid wholesale gas market, is upon us now.

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 efforts of all of us to do it, it will take time, and some give and take. I invite you join us on the journey, support the need for reform and continue to help us shape our thinking.

The prize is a resilient gas market, not just for these interesting times, but for the future.

~ENDS~

**Check against delivery**