

“Two sides of the energy coin: electricity and gas reform in Australia today”

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Introduction

Thank you.

And good afternoon ladies and gentlemen.

It's a pleasure to be with you - not the least because of the imminent inclusion of the WA electricity network regulation to the national framework. To support this work, the AEMC is participating in a number of working groups with Dr Challen's team at the Public Utilities Office and has seconded one of its network regulation specialists. But it's not all one-way - this involvement also informs the AEMC of the context, the challenges within this jurisdiction, and that there is not a one-size-fits-all approach to energy markets.

If electricity is one side of the energy coin, the other is gas. There is much to be learned from the West Australian experience because in many ways, it has already faced some of the challenges that are now being experienced on the East Coast, given the structural changes to domestic demand and supply dynamics, increasingly driven by the new LNG export industry.

So today, I think it's a good opportunity to share the AEMC's thinking about the direction and context of developments in sector - both gas and electricity - and some of the implications for managing reform processes of this magnitude.

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

Back in late 2014, COAG's Energy Council, of which Western Australia is of course a member, decided on a destination for the East Coast gas market and then asked the AEMC to draw the roadmap to get there.

Its vision for the creation of a liquid wholesale gas market was:

- 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 wholesale 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.

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's 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 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, there is only have a relatively small window of opportunity to adjust domestic gas market arrangements towards that vision - and make lasting change.

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

Today, I'd like to share the AEMC's thinking on this roadmap, the issues that are driving the desire for change and possible solutions. Some of the issues driving changes in the East Coast gas markets may be very familiar and in that sense, the proposed package of reforms may be of some interest as Western Australia's market adapts to the inevitable changes impacting 'internationalised' gas markets over the coming decade.

Rationale for changes in East Coast market

It is of course, the changing supply dynamics that are driving the rationale for reform on the East Coast. The structural changes ushered in by LNG exports, with impacts on patterns of gas flows and wholesale gas prices, are fundamental and irreversible changes to the Australian market. We can expect to see more volatility generated by these large loads and the coal seam gas fields that supply them. These changes are expected to significantly affect the East Coast gas market in two ways:

- The pattern of gas flows – large volumes of gas from Queensland and South Australia will supply the LNG export plants with end users in these states likely to source increasing volumes of gas from Victoria
- The volatility of flows and prices - market participants may want to transport large volumes of gas into the southern states for sale when the LNG export plants are unable to absorb supply due to an LNG train being taken offline, for example.

The best outcome would be the domestic market realising the benefits of this supply, by having 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, supported by appropriate levels of market information, to allow the sort of short-term trading response that would be required.

At the moment the East Coast has 3 different sets of facilitated wholesale market arrangements – a market in Victoria, a market around Wallumbilla in QLD and short-term trading markets in Adelaide, Brisbane and Sydney. All of these markets operate under different trading arrangements and to date, none have been sufficiently liquid to allow the development of risk management tools such as financial derivative products.

Now, in a market where the price of gas is low and stable, and producers and users are happy to enter into long term bilateral contracts, you might not need more tools to manage gas price and volume risks. But when there is uncertainty about where gas prices might go in the future, with increasing international linkages through LNG markets, or when producers are simply unsure about whether they will have the gas to fulfil contracts, you start to see those bilateral contract deals changing.

Contracts get shorter and less flexible and perhaps there is a greater price premium built-in. This leaves users with more risk to manage and without access to a well-functioning wholesale market, limited tools to manage their gas portfolio.

In Western Australia, the market has responded to the need for more short-term trading through the establishment of various trading platforms and brokerage services. Like the East Coast, however, the trading volumes in these markets have been small. The fragmentation of these markets limits the liquidity in the market and hence the development of meaningful, transparent wholesale gas prices.¹

Stakeholders on the East Coast have told us that access to pipelines, particularly for periods under 6 months, is greatly impacting their ability to trade gas in the short term. Specifically, the search and transaction costs in secondary capacity trading can be high, negating the commercial value that could be achieved through trading. The process can take weeks: it means finding a shipper that has spare capacity to trade. And unless their contract with the pipeline operator has exactly the right combination of receipt and delivery points, and type of service (for example, front haul, back haul) required, then the underlying gas transportation agreement must be opened up. The price at which this capacity is offered can also be high and as there is no market mechanism to help establish a price, it can be hard for smaller players or those not using the gas markets regularly to determine a 'fair' price. These kinds of arrangements, which I refer to as 'market mechanics', are not going to work in a market that is increasingly volatile in the short-term.

Finally stakeholders across the board have also said they don't have enough information about the market to be able to trade effectively. Well-functioning markets are, or course, underpinned by information that helps address information asymmetries between incumbents and new entrants, but also between the demand and supply side.

Three key elements of the roadmap for future market development

The AEMC has recommended a package of reforms in 3 areas that mutually reinforce each other:

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1. Changes to wholesale gas trading markets will concentrate trading at 2 points to reduce complexity and enhance liquidity
2. Changes in pipeline access arrangements that will improve the access to pipeline capacity by introducing market pricing mechanisms and trading platforms,
3. Better provision of information with an expanded Bulletin Board.

New ways of buying and selling gas

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 have therefore recommended that trading be concentrated at a 'northern hub' around Wallumbilla and a Southern hub utilising the existing Victorian market. These two areas reflect key intersections of demand and supply with different fundamentals that will drive the need for short-term trading.

In Victoria, we are proposing to augment the existing hub and transition from the compulsory trading model, where today over 80% of the gas flowing through the system is simply participants selling gas to themselves, and move to a voluntary, exchange-based trading model similar to 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.

Wholesale commodity trading of gas is already happening at Wallumbilla in Queensland and we believe it's the best location for the development of a liquid northern trading hub, given the intersection 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 if required.

Improving pipeline arrangements

Of course, liquidity in wholesale markets will never be improved unless you can get gas to and from those markets. So we've also suggested three main reforms to improve the transparency of pipeline arrangements and lower the search and transaction costs associated with trading pipeline capacity. The Gas Access Regime under the National Gas Law is applicable to Western Australia and will be directly relevant to WA pipelines over time.

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).

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 it is getting a ‘fair’ price for that capacity.

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 for pipeline operators and shippers in other countries that have recognised the key role that pipelines play in supporting a liquid and competitive wholesale gas market.

Better information

The last area of reform in our package of recommendations is enhancing the information provided to the market participants. The purpose is to allow easier access to the information needed to make informed decisions. This is one area in particular, where we’ve learnt a lot from the WA experience and the degree of information transparency provided by the IMO website. Now I know the journey to greater information transparency was not necessarily an easy one. By incorporating information on large users, more detailed information on actual flows and capacity outlooks, while addressing confidentiality concerns, the market here has been better able to respond to changing market dynamics than the East Coast markets.

Staying the course

So the gas reform agenda on the East Coast is substantial. It goes without saying, however, that any major policy implementation is difficult. The National Electricity Market didn’t happen overnight. Neither did the WEM (2006). A key success factor for both the NEM and WEM were governments having consistent positions over time on policy outcomes. This is important work - the creation of resilient gas and electricity energy markets that are transparent, flexible and can adapt to whatever the future may bring.

Experience tells us that major reforms with long-lasting benefits need to be implemented carefully and take time. The detail matters. There needs to be a well thought-out plan, with the right sequencing and a dedicated team to follow it through with a clear idea of the outcome. And the ability to be responsive and flexible when moving through the various stages.

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. Similarly,

it was the WA government's concern that the electricity market was not functioning as well as it could, that has driven the electricity market review and the reform agenda.

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.

These will be the same criteria that will be used when the AEMC begins making decisions that impact Western Australia's gas and electricity markets.

Overall, we believe that the biggest gains for electricity markets will come from pricing reforms, although we are mindful of the significant challenges in WA and the cost of supplying remote areas of the state. Linked to this, and dependent upon the successful management of the pricing reform process, is facilitating innovation and the development of a competitive energy services market. While retail competition is not yet a reality in WA, we support the careful consideration that is being given to its potential. In East Coast markets, it is consumer decisions that can drive investment, innovation and technological development in new products and services. Those decisions, rather than decisions made by networks or regulators, are most likely to deliver the best outcomes for consumers.

Closing remarks

Let me finish by saying that this is a great time to be part of the dynamic energy sector – both electricity and gas markets – for this state, the eastern states and the nation.

Delivering successful outcomes for consumers will take the efforts of all; it will take time, and some give and take.

The AEMC continues to offer its support for the WA reform agenda and invite you to engage with us, to help us shape our thinking and request change when it's needed.

Thankyou

~ENDS~

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