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Australian Energy Market Commission
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Lodged (by online): www.aemc.gov.au/Contact-Us/Lodge-a-submission

East Coast Wholesale Gas Market and Pipeline Frameworks Review – Wholesale Gas Markets Discussion Paper

The Energy Supply Association of Australia (esaa) welcomes the opportunity to make a submission to the Australian Energy Market Commission's (AEMC) Wholesale Gas Markets Discussions Paper.

The esaa is the peak industry body for the stationary energy sector in Australia and represents the policy positions of the Chief Executives of 34 electricity and downstream natural gas businesses. These businesses own and operate some $120 billion in assets, employ more than 59,000 people and contribute $24.1 billion directly to the nation's Gross Domestic Product.

The AEMC has an important role to play in defining the strategic direction for gas market development that is consistent with the COAG Energy Council's Australian gas market vision. A critical element of this is the development of a long-term strategy for the design and location of facilitated trading markets.

The Wholesale Gas Markets Discussion Paper provides a relevant contribution to the current debate in this regard. It will assist with framing the AEMC's broader assessment of the adequacy of current gas market arrangements. But the high-level nature of the Discussion Paper makes it difficult to provide targeted feedback on the overall merit/applicability of the three market design concepts presented. Further, the Association considers it premature to advocate for any particular market design option in the absence of a consolidated view on the adequacy of the current gas market framework. We note the AEMC is releasing further papers on the Declared Wholesale Gas Market (DWGM) and pipeline frameworks that will add to this picture.

Facilitated gas markets have an important role to play on the east coast, but there are limitations with the current framework

The east coast gas market is currently in a state of transition. Production costs are rising, political uncertainty is hampering onshore gas development and most notably, the liquefied natural gas (LNG) industry is driving a step change in demand. Given the size of the LNG export volumes that are anticipated on the east coast, it is clear continued resource development will be key to alleviating any supply/pricing pressures for domestic market participants over time. But flexible access to downstream markets will likely become increasingly more important, particularly given the desire for more transparent and shorter-term price signals.

The facilitated markets are generally considered to be beneficial to the extent they provide participants with a market-based mechanism for managing short-term trading positions. They also play an important role in enabling new entry to the gas market, providing participants with access to gas in the initial phase of market entry and allowing them to develop the experience and understanding of demand requirements before committing to long-term bilateral contracts for supply and transportation. In this regard, the DWGM is generally viewed as being more conducive to new market entry given the size and maturity of the market as well as pipeline carriage arrangements.

Despite these benefits, the complexities and pricing risks associated with trading in these markets may limit their overall value, particularly the Short Term Trading Market (STTM). The facilitated markets are mandatory and where a participant takes a position that is not covered contractually, they become exposed to potentially high prices in the event of market disruptions that cannot be effectively hedged. As a result, market participants generally seek to closely match their risk with longer-term bilateral injections and withdrawals to minimise exposure and manage their risk with longer-term bilateral contracts. Differences between the facilitated market designs also represent an added level of complexity for businesses operating across different jurisdictions.

Reducing transaction costs and minimising the risks associated with participation could support market development and ensure the facilitated markets deliver value to market participants in the future. This may potentially pave the way for the establishment of financial risk management products and ultimately a reliable price index. The ability to obtain a forward price for gas that is visible and tradeable is an important feature of liquid and transparent gas markets globally.

Strategic reform of facilitated trading market arrangements should be underpinned by a consolidated assessment of the east coast gas market

The Association is supportive of the AEMC examining the appropriateness of the facilitated market designs and developing a long term strategy for the location of facilitated markets on the east coast. This will assist with providing a more holistic and strategic view of changes required in the east coast gas market and how existing and potentially new hubs/facilitated markets fit within that framework.

In developing this long term view, the Association considers it prudent for the AEMC to first consolidate its position on the current state of the east coast market. This will assist with understanding whether the National Gas Objective (NGO) and COAG gas market vision are achievable under the current gas market framework, notwithstanding this may require resolution of the issues raised in the Stage 1 Draft Report.

In this respect, it is not yet apparent the AEMC has determined what the preferred common characteristics of workable hubs should be moving forward, and therefore, where change to existing hub designs is warranted. It is also understood the Australian Energy Market Operator (AEMO) is currently progressing work independently of the AEMC review to develop and implement a new Gas Supply Hub at Moomba.

The AEMC is also investigating and considering potential measures to better facilitate pipeline capacity trading. Flexible and transparent access to pipeline capacity is important for the development of a liquid and transparent commodity market. Where access to capacity is impeded, this creates the risk that the incremental benefits of more flexible short-term trades are missed, the value of which may grow as market dynamics continue to evolve. While the Association maintains an incremental approach to reform that has appropriate regard for existing contracts is the best approach to facilitating trading, the outcomes of the AEMC's assessment of current arrangements are highly relevant to the development of a long-term market reform strategy.

Significant wholesale gas market reforms must be carefully considered

To the extent the AEMC is yet to consolidate its view on the appropriateness of the current gas market framework, it is difficult to evaluate the appropriateness of the three conceptual models presented by the AEMC. There is also limited detail as to how the conceptual models would actually function in practice, so it is not possible to fully evaluate their feasibility. At a high level though, it is clear two key factors that must be taken into consideration include the size/characteristics of the east coast gas market and the potential impact of any regulatory reforms on existing contractual arrangements for pipeline transportation capacity.

As noted in the Discussion Paper, the east coast gas market has very different characteristics to the National Balancing Point (NBP), the Title Transfer Facility (TTF) and the Henry Hub. Unlike these highly liquid international markets, the east coast gas market is characterised by a relatively low number of market participants, low annual consumption and long point to point transmission pipeline connections. Long-term bilateral agreements for gas supply and transportation are also a prominent feature of the east coast gas market given the capital intensive nature of gas production/transportation. Collectively these factors may provide a barrier to increasing trading and liquidity on the east coast, particularly where the risks of trading cannot be effectively hedged.

Different trading hub designs also necessitate different pipeline transportation arrangements, with virtual trading hubs typically requiring a market carriage model. There are strengths and weaknesses to the market carriage and contract carriage models and a hybrid approach that applies different models to different assets is currently in place on the east coast. Notwithstanding concerns around more flexible access to short-term capacity, this framework has delivered significant investment in pipeline capacity and provided a reasonable balance of end-user protection with service provider protection and incentives.

As noted by the Productivity Commission in its recent assessment of the east coast gas market, regulatory reforms designed to improve pipeline capacity allocation under the contract carriage model (e.g. by extending elements of the market carriage model or potentially adopting mandatory pipeline capacity trading provisions) must be carefully considered.[1] Where alternative arrangements are considered necessary to accommodate changes to the wholesale gas market design (e.g. the implementation of a northern virtual hub), it is essential the rights of existing transportation capacity holders are not compromised. Further, the alternative arrangements must continue to facilitate timely and efficient investment in infrastructure.

With these issues in mind, the Association has the following high-level observations with respect to the three conceptual models presented.

[1] Productivity Commission 2015, *Examining Barriers to More Efficient Gas Markets*, Commission Research Paper, Canberra

- Concept 1: The replacement of the DWGM with physical trading hubs at Iona and Longford and a balancing hub at Melbourne could facilitate more efficient pipeline investment arrangements by allowing direct customer involvement and investment in pipelines. It is difficult to make a definitive judgment on this though, without full consideration of the available options for managing investment under a virtual hub model. The likely adequacy of market liquidity will also be an important consideration, as well as potential barriers to new market entry.

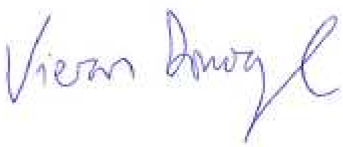
- Concept 2: This proposal is more consistent with an incremental approach to gas market reform in the Victorian market to the extent it retains a virtual hub that covers the Victorian DTS. But the implementation of a virtual hub at Wallumbilla is a significant change that would require economic regulation of pipeline arrangements in that region, the merits of which require further consideration. The rationale for, and implications of including the Brisbane demand hub in the northern virtual hub must also be examined.

- Concept 3: The creation of two large virtual hubs covering the east coast would represent a significant change from current arrangements. It would effectively require the implementation of market carriage transportation arrangements across the entire east coast and therefore significant and complex regulatory intervention. As noted in the Discussion Paper, consideration would need to be given to infrastructure investment incentives and how infrastructure investment (e.g. gas processing, pipelines, storage facilities) would occur under this framework.

The Association is broadly supportive of examining opportunities to facilitate more flexible and transparent access to gas supply and transportation capacity. In developing and pursuing work in this space, continued industry engagement is essential. Further, any decision to proceed with significant changes to current market arrangements must have regard to existing property rights and should ultimately be informed by robust cost-benefits analysis.

Any questions about our submission should be addressed to Shaun Cole, by email to shaun.cole@esaa.com.au or by telephone on (03) 9205 3106.

Yours sincerely



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