28 September 2015

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Dear Commissioners

Lodged electronically: www.aemc.gov.au (GPR0003)

East Coast Wholesale Gas Markets and Pipeline Frameworks Review, Wholesale Gas Markets Discussion Paper, 6 August 2015

EnergyAustralia welcomes the opportunity to make a submission on Wholesale Gas Markets Discussion Paper (the Paper). EnergyAustralia is one of the country's leading retailers, providing gas and electricity to more than 2.6 million customers. We own and operate a range of generation and storage facilities, including coal, gas and wind assets, in NSW, Victoria and South Australia.

We thank the AEMC for their leadership in gas market reform. The Paper outlines three high-level concepts which provide a catalyst for discussion on various mechanisms to improve how gas is traded and investment decisions are made on the East Coast. The viability of each model will depend highly on how a more detailed design fits with the physical infrastructure and market structure. Our response is largely theoretical and does not commit to a preferred design.

In an already turbulent time in the gas market, reform should be incremental and purposeful with benefits which can be quantified. Progression from here requires more detailed analysis of any potential reform path. AEMO's work on the details of potential designs of the Wallumbilla Single Product has demonstrated that some level of bottom-up design should be undertaken together with a top-down approach. This would involve delaying a decision on the high-level market reform direction.

Domestic gas users have become price takers in an international market. The price volatility introduced by the scale and international price linkage of the LNG export industry requires improved markets and risk management. The current East Coast markets are not designed to cope with large and temporary swings in supply/demand conditions. We believe transparent markets that enable users, participants, pipelines, and producers to signal the price at which they are willing to transact, as well as facilitation of these transactions, improves the position of all parties.

The current demand hubs were structured around pricing gas at the point of consumption whereas the proposed designs recognise the importance of trade at point of production. Concept 1 proposes to support upstream trade with Gas Supply Hubs (GSH). Concept 2 and 3 incorporate production and demand nodes into the same hub.

Each proposed reform direction in the Paper will offer greater consistency across the East Coast market. The costs of reform, and whether the high-level concepts translate well when the details of the physical system are incorporated, will become clearer once the models evolve.

All three concepts would introduce improvements to price discovery and trading. Long-term visibility of prices is important to support new investment. This is as relevant to gas users as it is to the upstream supply chain. With increasing gas prices, substitutes such as electricity will become more attractive to many users.

Concept 1

Concept 1 has Gas Supply Hubs at supply nodes and simplified demand hubs at demand nodes. The proposed market concentrates on providing operationally simple mechanisms for physical trading between portfolios of both longer term supply and on the day balancing. This offers consistency across the East Coast in how and where gas is traded and balanced. We support the introduction of more trading locations which provides flexibility and localised pricing.

A market based around the physical trading of gas is the status quo and so improvement on this with additional locations is relatively risk-free with minimal reform costs. This will provide improved price discovery, however the refined objectives of the demand hubs may allow for portfolios to operate largely off-market which could reduce market transparency.

The brokerage model used in the Wallumbilla Gas Supply Hub offers a simple mechanism to transact future physical delivery but requires the buyer to arrange transport from the hub. Transport capacity trading is developing and participants with established transport arrangements with unused capacity would be the heaviest users of the service and so this may not be a significant problem. We support the development of GSHs at supply nodes at Moomba and Victoria.

Simplified downstream markets designed mainly for balancing would be appropriate in this market as increased upstream trading would limit the depth of bids and offers downstream. New entrants and major users would find it more difficult to participate directly in this model.

We believe this model is an efficient way to facilitate the optimisation of existing portfolios and will enable more dynamic market responses to price shocks and supply/demand condition changes. However it may cement the role of long-term supply and transport contracts and current market structure.

Concept 2 and 3

Concept 2 and 3 would create northern and southern virtual hubs which would include the majority of production on the east coast. Concept 2 outlines more localised hubs around major supply/demand centres with balancing markets at Sydney and Adelaide. Concept 3 expands the zones to include every node across the East Coast.

The advantages of concept 2 and 3 come from the inclusion of the major production facilities in the hubs. The Paper suggests that trading should occur similarly to GSH arrangements. However with these zone boundaries, supply sources could participate directly in the spot market. The market operator would schedule production facilities directly removing operational obligations from supply contracts. This will enable supply contracts to incorporate derivatives or other financial products which reference the spot price and allow for greater intra-day flexibility.

This could limit the uncertainty for participants operating in supply constrained conditions during Force Majeure (FM) events. The current scheduling and curtailment process during management of system security issues is somewhat of a lottery. The differences in treatment of FM events in the STTMs and the DWGM could also be addressed.

Concept 3 will allow for a harmonised gas scheduling process but the benefits of this are unlikely to outweigh the reform costs. Simpler reforms may still offer significant albeit imperfect improvements to allocative efficiency. Cross-jurisdictional issues may also provide a barrier to national reform.

Financial trading

We are unsure that a liquid derivatives market would develop under any of the concepts proposed. Primary sellers of supply and transport are not exposed to the spot price with their liability limited by Force Majeure and other clauses.

A market where supply and transport contracts could be reconceived as financial contracts may enable a liquid derivatives market. This would require primary sellers being active in the spot market and scheduled directly by the market operator. This enables contracts that reference the spot price without operational obligations.

Financial instruments can provide price certainty as well as enable operational flexibility. Where costs of production change, these can be reflected in offers which will be scheduled accordingly by the market operator. The depth and liquidity of the market would be aided by both primary producers and secondary traders utilising a central exchange for financial instruments. Higher participation by new entrants, major users, and speculators would be expected.

Market information

EnergyAustralia's submission to the *enhanced information on pipeline capacity trading rule change* outlined additional information required by the market. This includes a clearer and more detailed presentation of physical gas flows and an improved long-term capacity outlook. Voluntary balancing only arrangements at demand hubs such as suggested in concepts 1 and 2 could result in a more opaque market as much of the pricing and portfolio information provided currently would not be available.

Locational signals and investment

Congestion internal to the hubs will cause supply/demand conditions to differ across the hub. The DWGM became complicated as cost reflectivity was introduced into a model which provided advantages from the socialisation of these costs. Where price signals were lost from the aggregation of nodes into a single virtual hub, they were ultimately provided through complicated mechanisms including peak day injection and congestion uplift charges. Congestion internal to the STTMs can manifest as 'counteracting MOS'.

We have similar concerns with concept 2 and 3. The simplicity of a single price covering a large area will be lost when mechanisms are introduced to provide locational pricing, investment signals, and capacity rights. The development of the Wallumbilla single product has demonstrated the difficulties in the implementation of a *prima facie* simple idea.

For long-haul pipelines, contract carriage arrangements have been successful in providing infrastructure investment to meet the demands of gas users. End users have not borne the risks of this investment and access regimes and competition have ensured acceptable prices. The virtual hub in concept 3 would require regulated investment over an area where the

supply/demand dynamics are not easily forecast. The contract carriage arrangements, or equivalent rights, should be retained.

Short-term allocative efficiency

Currently, price differentials greater than transport cost differences appear between demand hubs. This is because supply must be allocated to a large extent before the market clears and the marginal price of gas is known. Concept 3 would provide the capability for potentially improved allocative efficiency across hubs. Concept 1 and 2 with reduced objectives of downstream markets in Sydney and Adelaide may make it more difficult to understand how consumers value gas at those hubs.

We are happy to assist the AEMC in further understanding current operational and contractual arrangements which may have bearing on gas market reform. EnergyAustralia has yet to come to a conclusion on a preferred design and will seek to be involved in working groups and consultations to understand the impacts to our business and the gas market more broadly. This Paper has identified opportunities for incremental improvement on the current market. The larger reforms will depend on results of a cost benefit analysis.

If you any have further questions please contact me on (03) 8628 4518 or at Ben.Hayward@EnergyAustralia.com.au.

Regards

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