Major Energy Users Inc.

26 March 2015

The Commissioners
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Sent by: online lodgement

Dear Sirs

DISCUSSION PAPER
East Coast Wholesale Gas Market and Pipeline Frameworks Review
GPR0003

Major Energy Users Inc (MEU) attended the AEMC forum addressing the East Coast Wholesale Gas Market and Pipeline Frameworks Review and has reviewed the AEMC Discussion Paper related to the forum.

The MEU is very concerned about the direction the domestic east coast gas market is heading. The decision to allow export gas from the east coast in the quantities permitted has created an entirely new dynamic for domestic gas users, ranging from very large users right through to residential users. It is insufficient to assume that the current gas market structure will adequately provide a competitive outcome for domestic gas use when considering the massive increases in demand that are occurring with gas exports.

In particular, the MEU recognises that the domestic gas market will now be exposed to major changes as a result of the decision to allow unfettered gas export from the east coast, with the two core concerns being:

- The potential that there will be insufficient gas for the domestic market in the near to medium term. There is a real concern that there will be insufficient gas from the coal seam gas fields on which export was based and that gas developed for the domestic market will be diverted to make up any shortfall in the amounts contracted for export. Whilst the most recent assessment by AEMO indicates there may be a reduction in the shortfall, there is still a shortfall forecast and it is probable that large gas users will be impacted first as it is common practice that when gas shortages occur, large gas consumers are the first to be constrained.

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- Despite the assumption that domestic gas prices would reflect the net back international price for gas, this is not occurring and domestic gas prices are rising well in excess of the net back futures prices for international gas[1]. That this is occurring is not unexpected as there is so little competition for gas production (there being only a small coterie of dominant gas producers effectively controlling gas production for the domestic market - BHP, Esso, Origin and Santos) which means that competition at the production level is insufficient to drive prices to the net back international price.

It is not proposed by AEMC that these two concerns will be addressed in any practical way by the east coast gas market review yet they are fundamental to ensuring there is a competitive market. The MEU would expect that the AEMC to highlight these as a part of its response to the CoAG Energy Council.

The MEU notes that the Terms of Reference provided to the AEMC basically seem to seek a "fine tuning" of the east coast gas market although it makes reference to encouraging competitive supply. However, the "elephants in the room" are the two basic concerns identified above and it appears that they are not being addressed in any practical way within the Discussion Paper. The MEU notes the AEMC observation that such investigation is "outside the AEMC's remit" but the MEU cannot see how the AEMC can address the issues it considers to be within its remit without addressing the core issues. The MEU considers this is a major oversight by the AEMC as each of the issues identified in the Discussion Paper will be overshadowed by these two aspects.

The solution to both of the issues is for there to be the ability to increase supply and for there to be increased competition in supply to the domestic gas market. This means there is a need to investigate aspects such as:

- Gas reservation for specific future gas developments as indicated by the Queensland Government review undertaken in 2009 and 2010;
- "Use it or lose it" with regard to gas exploration licences. An existing licence holder (especially one of the four dominant gas suppliers to the domestic market) has an incentive to limit gas supplies to support the higher prices being sought under the guise of international pricing impacts;
- Removal of joint marketing. Whilst joint marketing might have had a rationale in the formative years of gas market development, it has little relevance now and acts to limit competition;
- Resistance from land holders to exploration and development. Governments are imposing bans on on-shore gas exploration reflecting land holder resistance. Land holders suffer the negative impacts of such activities but get

[1] For example, as Appendix A see the attached article from the AFR 18 March 2015

no benefit; if land holders received an appropriate level of benefit this might reduce their resistance;

- Governments are restricting exploration and development of on-shore gas fields and therefore are precipitating potential shortfalls. Yet there is no clarity on how gas shortages might be allocated in the event of insufficient gas to meet domestic demand; and
- Government investment in infrastructure to ensure there is needed infrastructure provided to increase the source of gas for the east coast market (eg linking the northern gas market to the east coast gas market).

The MEU considers that in the absence of active attention to increasing supply for the domestic market, "fine tuning" of the current gas market will provide little benefit in addressing the core issues.

The MEU notes that the key points arising from the forum reflect the MEU concerns in that presenters identified:

- Significant challenges to the existing arrangements in the east coast due to LNG and its effect on gas prices, transmission arrangements and on the physical flows of gas;
- There is an urgent need for the AEMC/CoAG to drive real reforms to both the wholesale gas markets and the transmission arrangements;
- There is an urgent need to consider reforms of the east coast gas market, including both short term “wins” and longer term more strategic reforms;
- The lack of integration of the east coast gas markets is a major problem given the core issues. It is particularly important to consider any reforms in the context of the better integration of the whole of the east coast market; and Improved transmission arrangements are seen as fundamental to establishing a more efficient and integrated east coast gas market. Whilst the pipeline industry believes it is responding to the challenges, other speakers considered that progress is too slow and more fundamental reforms are required, including possible intervention by governments.

There is clearly a consensus that the two "elephants" identified by the MEU above must be addressed if there is to be significant improvement achieved.

The MEU agrees that investigation into and refinement of the east coast gas markets are needed. During the forum the MEU noted that others considered improvements are needed, such as:

- There is a need for investment in transmission capacity at critical points in the system – to better facilitate bi-directional gas flows, storage, swaps, liquidity, etc.
- Current transmission arrangements are not delivering efficient outcomes, as there are significant impediments to access to pipelines and capacity trading;

- Information asymmetry is a major barrier to efficient trading, and must be addressed – this goes beyond enhancements to the existing gas bulletin board and voluntary arrangements; and
- There needs to be further development of the supply hubs – currently Wallumbilla (in SW Qld) is developing as a supply hub (commenced early 2014), but is hampered by internal physical constraints at the hub. A second supply hub at Cooper Basin is another option promoted by AEMO. AEMO advises that this can be developed at a reasonable cost, and it is difficult to understand why CoAG would not proceed with a cost benefit of this "no lose" option as quickly as possible. To the extent that this would facilitate investment in a North-South pipeline, a Cooper Basin supply hub has real potential to ease shortages of gas and increase competition.

In addition to these, the MEU notes that there is still considerable amounts of gas used domestically that does not transit the STTMs or the Wallumbilla supply hub.

The MEU provides the following observations about the east coast gas markets and concerns raised by MEU members.

.**Wholesale market management**

The MEU recognises that both the DWGM and the STTMs have limitations but it must be noted that each is designed for a specific gas delivery system and reflective of the needs of the markets they are designed to serve. The MEU notes that even with their limitations, they provide transparency that was lacking before they were implemented.

One of the key limitations of both the DWGM and the STTMs is that they only provide the cost of gas at the margin (ie on a net market basis) and not what the cost of gas is across the entire market - this is in contrast to what is seen in the electricity market.

The lack of such a market or better forecasts of gas availability, capacity and price, limits the provision of a secondary market or efficient spot pricing mechanisms for assisting consumers:

- Use the markets for negotiating gas contracts - access to "hard" data is a key element to equitable outcomes for supplier and user in negotiating contracts;
- Use of the markets as the basis for operating on a "spot" basis is very limited due to the complexity of the gas markets and the various adjustments made ex post. For example, the possibility of very high ancillary payments (uplift charges) in the DWGM is a major deterrent for direct participation by consumers and by small gas retailers. Similar, if less extreme, risks exist in the STTM. In contrast, a number

of consumers access their electricity needs on the spot market and provide demand side involvement when they shed load when prices rise sufficiently high. Demand side involvement in the gas markets is very limited, with the major involvement being in the supply of "contingency gas".

A further issue for consumers is that consumers remote from the STTMs have difficulty in using the STTMs or the data they provide. For example, consumers served by laterals off transmission pipelines upstream of STTMs are unable to access the gas provided as "spot" at each STTM or provide demand side responses. These consumers also find the use of the STTM data limited in contract negotiations for future gas supplies.

Contract carriage and market carriage

The decision to use contract carriage as the main approach for the gas markets except in Victoria was a decision based on the reality that many pipelines were privately owned and the owners preferred this model due to its consistency with pipeline operation in other jurisdictions.

The capacity for firm capacity contracts provided certainty to existing shippers and to investors in the pipeline. However, from a consumer's viewpoint this has resulted in a number of significant shortcomings as noted in following sections.

The decision to implement market carriage in Victoria was possible because the pipelines were government owned when the market was developed and there was a market basis needed to reflect the physical features of the transmission network in Victoria; investigation at the time indicated a model similar to that used for electricity networks would provide a better outcome for managing the gas market and changes have not resulted in a lesser need for such a model.

Certainty of accessing capacity in the DWGM was implemented through the introduction of AMDQ that was allocated to consumers, and as capacity increases are required, then new AMDQ could be allocated. The risk to consumers is that new AMDQ now tends to be allocated to retailers rather than the consumers that need this additional capacity. This increases the risks for consumers should they want to change retailers, especially if the new retailer has no AMDQ available to support the increase in demand sought.

The MEU considers that both models have drawbacks but highlights that market carriage works well for electricity markets and provides somewhat more efficient price signals. The more to intraday pricing on the DWGM has also reduced the risk of extreme ancillary costs (uplift charges) as it enables faster physical and financial adjustment to shortages of supply or capacity.

The MEU is not aware of any extreme ancillary payment events since the introduction of intra-day pricing. Given some simplification of the process, it is possible that these changes will facilitate more effective gas demand management by large consumers.

Pipeline investments for export to other regions

A major issue raised in the Discussion Paper is that export to other regions from Victoria might be limited due to the way the DTS is regulated and that the investment needed for such exports might not be timely.

In this regard, it is important to note that the cost of increasing the capacity of the DTS to permit exports would otherwise be funded by Victorian consumers rather than by the consumers that will benefit from the increase in exports.

This issue is addressed in the electricity market through the introduction of the allocation of the inter-regional TUoS where importers of electricity provide some funds for to offset the costs incurred by an exporting region to provide transport of the energy to the regional boundary.

The MEU recognises that improving export arrangements between the market hubs is an essential development and should be a focus of the AEMC's review. However, the MEU also considers that investment in increased transport within the DWGM to provide increased export can readily be addressed with the beneficiaries of the increased capacity paying for in-region capacity required to enable the additional gas sought as export.

Complexity of the models

The MEU agrees that the DWGM is complex but notes that the STTMs are also not uncomplex. The MEU was closely involved in the development of the STTMs and also in the development of the DWGM and recognises that competing requirements caused much of the resultant complexity.

Specifically the MEU points to the concerns raised regarding the Market Operator Service (MOS) in STTMs and the ability for shippers to use the balancing between the flow controlled pipelines and the pressure controlled pipeline to cause harm to other shippers and consumers.

The MEU considers that energy markets are complex (eg the electricity market and its many variants) and notes that complexity can be a result of attempting to ensure that the markets operate in the long term interests of consumers

Coverage of monopoly assets

The MEU is aware that there are a number of pipelines that are effective monopolies but are not regulated. Examples of these are laterals off unregulated pipelines such as off MAPS (eg to Whyalla and Angaston) and off SEAGas (SESA and SEPS to Mt Gambier).

There are important regional industries and regional cities that are provided gas from a single gas pipeline only. This is quite different than the situation for the Melbourne, Sydney and Adelaide hubs where there are at least two separate transmission pipelines. In contrast, a single monopoly pipeline which is unregulated clearly provides the potential for the pipeline owner to garner monopoly rents.

The MEU is aware that there is an ability to seek pipeline coverage within the Gas Law. The MEU is also aware that an attempt has been made to get recoverage of a pipeline that is clearly a monopoly (the SEPS in South Australia which was previously listed as a covered pipeline due to its monopoly characteristics) but this was unsuccessful, indicating that the Gas Law processes are insufficient to provide appropriate competitive access for shippers and down-stream protection for consumers.

The current Gas Law provisions for granting coverage of a pipeline require the access to "materially increase competition either upstream or downstream". However, the structure of the four “criteria”, each of which must be satisfied before coverage can be granted (or application to remove coverage opposed), create a major hurdle to any objector.

It must be recognised that the owner of a monopoly pipeline can impose monopoly rents on users even though there might not be a change in competition upstream or downstream. The MEU considers that AEMC needs to include in its review whether the Gas Law provisions address the actuality of a monopoly pipeline being able to avoid some regulation because of the way the Gas law is drafted. This would include whether the provisions under the National Third Party Access Regime are sufficient for these unique situations.

Hoarding of pipeline capacity

Hoarding of capacity is where there is a constraint imposed on access to transportation even where there is adequate capacity for increased access. The MEU notes that "hoarding" of pipeline capacity was raised as an issue during the forum.

The MEU notes that this is largely a risk for the STTM markets and pipelines outside the STTMs, as the structure of the DWGM in Victoria does not allow shippers to hoard capacity on the principal transmission system (PTS) pipeline (although this is a risk in the non principal transmission pipelines in Victoria). In the DWGM, the hoarding risk is potentially around the hoarding of AMDQ credits (as described above).

The MEU is aware that there are a number of instances in gas transportation where a shipper contracts all the available capacity on a pipeline and uses this to prevent competition to it in downstream activities. In theory, the pipeline owner can offer interruptible supply to a prospective shipper even though all firm supply might be contracted. In practice, either interruptible capacity is offered at a higher cost than firm capacity or not at all as the pipeline owner might consider that it could lose the contract for all the firm capacity if it offered alternatives. Either way, consumers pay more than a competitive market would provide.

While implementing more effective mechanism to facilitate trading in capacity might assist in reducing the incidence of capacity hoarding, this is not certain as the shipper that is hoarding might not want the resultant competition that releasing its capacity might cause.

The AEMC needs to address this issue as it results in a restraint on competition in the gas market, although the solutions may be different between the DWGM and STTMs, and for pipelines outside the markets.

Investment in increasing pipeline capacity

Under contracted transmission arrangements, existing access holders are currently given primacy over new access seekers when allocating capacity. When there is insufficient capacity for the new access seeker, the new access seeker is required to fund all the augmentation. Generally, the high cost of an augmentation allocated to just the new entrant creates a barrier to access.

The current approach does not reflect the value the existing capacity has to all of the access seekers (existing as well as the new) as the new entrant could well consider paying a higher price for access (but less than the entire cost of augmentation) than the existing capacity holders.

It would be inefficient if a new entrant was precluded from entering the market due to a financial barrier. For regulated pipelines, increased capacity is provided as required and the costs for providing the increased capacity are socialised so that all shippers pay the same rates for the same service - this is what occurs in a market carriage arrangement such as for electricity and gas distribution[2].

[2] Adding new capacity permits the additional new demand to share the costs and eventually reduce costs to all as the costs are shared over a greater volume

The issue of priority for allocation of capacity needs to be addressed, particularly with reference to the contract carriage transmission market.

Access to the Victorian PTS raises different issues, including the need for the consumer/shipper to access AMDQ, or to change the AMDQ allowance. On the other hand, there is a structured mechanism for sharing the costs of expansion across all or a segment of consumers, and this is managed by the independent operator AEMO and regulated by the AER.

The DTS owner (APA) suggested at the AEMC forum (and elsewhere) that the DWGM does not provide sufficient signals to encourage new investment in the DTS. The MEU believes that this criticism needs to be rigorously assessed by the AEMC as, to date, AEMO has also provided an independent mechanism in its Victorian transmission planning role. There may be opportunities to refine that process but it is not clear to the MEU that the stated concern sufficiently warrants a major restructure to or abandonment of the DWGM.

Similarly, APA has suggested that the DWGM inhibits the development of new pipeline services, such as park and loan. Again, the MEU is not convinced about the extent to which these services are required in the DWGM and, if they are, does it require major change to the gas market structure in Victoria. At this stage, the MEU does not see that need.

The MEU would be interested in further discussing its views with the AEMC and is open to providing more explanation if needed

Yours faithfully

David Headberry
Public Officer

Appendix A

Australian Financial Review Updated Mar 18 2015

Manufacturers get no joy from falls in export gas prices

Large east coast gas users fear they may suffer the worst of two worlds if falls in oil-linked export gas prices deter new players from entering the domestic market without lowering domestic prices

by Ben Potter

Qenos, Orora and other big manufacturers say they have not had any joy from falling international gas prices when it comes to securing local supply in NSW and Victoria.

The companies are big users of natural gas and fear the worst if falls in oil-linked export gas prices deter new players from entering the domestic market but do not lower domestic prices because of tight supply.

To ease the squeeze, Manufacturers Australia, which represents Orora, Incitec Pivot, Bluescope Steel, CSR and other big manufacturers, is relaunching a campaign for more competition in the gas market.

A priority is for Victoria and NSW to relax restrictions of onshore gas drilling that have prevented smaller companies such as Ignite Energy, Lakes Oil, Metagasco and Beach Energy from exploring and developing prospective fields.

But the Baird government in NSW is moving cautiously in the face of a populist anti-gas push that has co-opted the Labor opposition, and the new Labor government in Victoria has extended the state's moratorium until at least spring 2016.

The fall in oil-linked liquefied natural gas prices has coincided with lower domestic spot gas prices. But manufacturers say this reflects production surging in anticipation of export shipments and they are still not seeing good offers for long-term volume gas.

"We have not seen any reduction in gas prices and even though there's been a reduction in the overseas price it's hard to see how that would flow through to the domestic price given the supply, demand imbalance," said Peter Dobney, group head of resources and energy at packaging group Orora.

He said offers for long term contracts post 2017 – when LNG exports accelerate and domestic shortages and surging prices are feared – didn’t look any better.

"We have got a couple of offers but I wouldn’t call it a competitive market," he said.

Manufacturing Australia chief executive, Ben Eade said the impact of the oil price drop on members’ ability to secure long-term gas contracts had been "negligible".

"What we’re really concerned about with the oil price slide, is if it discourages second tier suppliers from getting into the market that could make a bad situation worse."

The group will release a report next week calling for more competitiveness and transparency in the market, a focus on supply security and the role of "use it or lose it" policies for producers, more pipelines and trading hubs, and steps to encourage new entrants.

At the moment new entrants are shut out by a moratorium on onshore drilling in Victoria and a punitive approach to second tier companies in NSW, where Metgasco is fighting the suspension of its drilling licence near Casino by the coalition government.

About 85 per cent of commercial gas reserves on the east coast are in the hands of four groups - BHP Billiton/ExxonMobil, Santos, Origin Energy and BG.

Mr Eade said the "blunt instrument" of domestic gas reservation – sought by the Australian Workers’ Union and some manufacturers – would not help bring more producers into the market.

Politicians would face "louder and louder calls for blunt intervention" in the gas market if they didn’t take other steps to make the market work better, he said.

Qenos, which makes polyethylene for use in the manufacture of plastic pipes, wheelie bins, tanks, industrial film, milk and other containers at Altona and Port Botany, also said things were no better.

"We have not been flooded with calls to say ’we have got gas for long-term contracts’," said Rod Coughlin, corporate affairs manager at Qenos.

"The market players know our situation. We’d be a fairly attractive customer for a gas supplier based on our load and usage."

Plastics and Chemicals Industry Association chief executive, Samantha Read said: "If the drop in oil prices dampens investment by the gas industry in new gas supplies certainly that will put additional strain on the domestic gas market and this would be a concern for the industry."

Australian Industry group chief executive, Innes Willox said: "Those oil movements have not yet translated into a visible lessening of price and supply pressures in the domestic market. And since oil prices must recover sooner or later, the worry is that domestic users may not see relief at all."