Australian Energy Market Commission

SPEECH BY CHAIRMAN JOHN PIERCE AT EUAA ANNUAL ENERGY CONFERENCE

East Coast Gas Market Development

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Thank you to the Energy Users Association of Australia for the invitation to speak today.

First, a few words on what we do for those who may not be familiar with the AEMC.

We are an independent national body responsible to the members of the COAG Energy Council. We have two main jobs:

- We provide advice to the COAG Energy Council on improvements to regulation and energy market arrangements that will benefit energy consumers; our so called market development role; and

- We also have a statutory role where we make rules under the national electricity, gas and energy retail laws that govern how energy markets operate.

All of our work is guided by the three legislated national energy objectives: the national electricity objective, the national gas objective, and the national energy retail objective.

Each of these objectives requires us to assess everything we do in terms of how it will best benefit the long term interests of energy users with regard to price, quality, safety, reliability and security of supply of energy.

This is a time of immense change in the energy sector.

We're seeing the development of a range of new products and services – battery storage, microgeneration and building control systems - which will fundamentally change how large users participate in energy markets, with increasingly rapid technological change driving even more innovation.

A common theme in much of the AEMC's work – and no doubt in a lot of today's discussion – is uncertainty: uncertainty about how quickly some technologies may be adopted, uncertainty about consumer responses, uncertainty about future investment requirements, and uncertainty about the pattern and levels of demand and supply in a carbon-constrained world.

While uncertainty and rapid change have been features of electricity markets in recent years, our gas markets have been experiencing their own level of upheaval.

As gas users in this room would be very aware, a fundamental structural change in Australia's east coast gas market is underway.

This year saw the first exports of LNG from Gladstone. A gas market that was isolated is now linked to the international gas market.

This presents significant opportunity for Australia, with the investment and earnings from LNG projects boosting our GDP and employment.

But, this is also leading to unprecedented shifts in supply and demand, which are driving changes in gas flows and prices domestically, and fundamentally changing conditions for Australia's gas consumers, with particularly stark effects for large users of gas who rely on it as a feedstock for manufacturing.

Out of our manufacturing sector – which currently accounts for nearly 9% of GDP and employs 1 million people[1] - around 45 per cent of businesses use gas as their main source of energy[2]. In addition, more than four million Australians use gas for heating and cooking.[3]

With this significant transition underway in our east coast gas market, and being acutely mindful of the opportunities and challenges that this presents, we need to respond to these changes and develop regulatory frameworks that promote efficient outcomes.

In recognition of this COAG Energy Council has asked the Commission to review the facilitated gas markets.

Today I'd like to give an overview of the AEMC's approach to gas market development in the two key areas of wholesale markets and pipelines.

The COAG Energy Council has set out a clear vision for Australia's future gas market – one where market signals guide investment and supply.[4]

This Vision – along with the National Gas Objective – guides the AEMC's Gas Reviews, which are looking at how gas can get to consumers in the most efficient way.

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[1] *Gas market transformations – Economic consequences for the manufacturing sector*, Deloitte Access Economics, July 2014 p.17

[2] Santos submission, Inquiry into the supply and cost of gas and liquid fuels in NSW, 14 Jan 2014, p.4

[3] *Electricity Gas Australia*, esaa, 2015 pp.63-63

[4] The Council's vision is for the establishment of a liquid wholesale gas market that provides market signals for investment and supply, where responses to those signals are facilitated by a supportive investment and regulatory environment, where trade is focused at a point that best serves the needs of participants, where an efficient reference price is established, and producers, consumers and trading markets are connected to infrastructure that enables participants the opportunity to readily trade between locations and arbitrage trading opportunities.

Our work will set out a roadmap for developing wholesale gas markets and transmission pipeline arrangements which deliver greater flexibility and more options for market participants when buying and selling gas. It is this flexibility which will promote competition and efficient outcomes.

Since publishing our Stage 1 Report in July – which outlined a number of short term practical actions to boost the efficiency of the gas market – we have published:

- a Wholesale Gas Markets Discussion Paper;
- a Victorian Declared Wholesale Gas Market Discussion Paper;
- a Pipeline Regulatory Frameworks Discussion Paper; and
- multiple papers on information provision and the Bulletin Board.

Many of you have been involved and made submissions, and we thank the EUAA, and many of you here, for your continued engagement with us on these workstreams.

We will be working right up to the end of the year to deliver our second set of major reports to the Energy Ministers for their consideration in early December.

We are not undertaking this work in isolation. The AEMC is working with the Australian Energy Market Operator and we are also engaged with the ACCC as it conducts its Inquiry into competitiveness of the Wholesale Gas Industry. Although the ACCC's final report isn't due until April next year, we're working closely with their project team so any relevant findings can inform our Review – and the Competition and Consumer Act enables the ACCC to share information with the AEMC on a strictly confidential basis.

Before I go further I'd like to clarify that the work being undertaken by the AEMC will not address upstream supply-side issues, such as moratoriums on coal seam gas exploration and development, which may be hindering gas supply. These are important issues – and we have encouraged governments to review their approach given that supply constraints only exacerbate the issues that changing market dynamics can bring.

We are confident, however, that our work to develop better functioning markets will apply regardless of the policy approach to supply-side issues, so our focus is on improving market flexibility and making it easier for participants to buy and sell the gas that *is* available.

In the past, the typical way of purchasing gas has been through longer term bilateral contracts. The pricing structure for these contracts was generally based on the cost of production plus an annual price escalator such as the CPI.

The bilateral contracting process has been fairly opaque, which is why it is difficult to establish if, or by how much, domestic gas prices have increased in recent times, or if the number of new gas supply offers to users has been declining.

Of course the ACCC is now shining a rather large spotlight on some of these arrangements.

The ACCC Chairman – Rod Sims – noted in a speech a few weeks ago that "gas users were largely right" in claiming that they are facing difficulties in securing new gas supply contracts.

For the AEMC, this highlights the importance of developing a liquid wholesale gas market to provide participants with greater flexibility alongside of long term contracts when buying and selling gas.

The ability to trade gas on a liquid wholesale market, on an equal basis to other players, and hedge price risk, lowers barriers to entry and promotes competition.

Trading gas through well-functioning markets is fundamental to consumers being able to know whether the gas price reflects underlying demand and supply, and basically, to know that they're getting a fair deal, which in turn provides signals for the efficient allocation of gas across the economy.

In this sense, trading markets can complement gas users' bilateral contracting activities by becoming a credible alternative source of supply.

We know that many large gas consumers use the Short Term Trading Markets and the Victorian Declared Wholesale Gas Market to optimise their bilateral contracting positions. Gas users obviously want to be able to continue to access these markets and I'd like to reassure businesses that while we may recommend reforms in this area, the objective is to increase trading flexibility and liquidity, not reduce it.

A question in the AEMC's mind is therefore, what type of gas market structure would best support the Energy Council's Vision?

We don't yet have a fixed idea about the exact market structure – for example the number and location of supply hubs or trading zones. We are also comparing physical and virtual hub designs – which both have their advantages and disadvantages.

These are issues we are currently working through – together with stakeholders.

Our overall focus is on options to enable gas to be bought and sold via a wholesale market that delivers a clear reference price that users can trade around and hedge.

This brings us to gas pipelines. A well-functioning gas market relies on gas being able to flow easily across the pipeline system to where it most highly valued. This requires ready access to pipeline capacity, at an efficient price.

The arrangements which have been in place to date have been good at getting infrastructure built. Since the early 1990s, the length and capacity of the gas transmission network in Australia has trebled and around $5 billion has been invested in new transmission pipelines and expansions since 2000.[5]

Gas pipelines are big, long term investments. It is likely that increasing uncertainty will be a feature of gas markets over the next decade – and uncertainty obviously impacts on investment decisions. This context makes it even more important to understand how any proposed change to the regulatory framework could potentially impact on investment decisions.

Last month we released a Discussion Paper which considers whether the existing pipeline access arrangements are fit-for-purpose and will support more active short term trading of gas.

The paper also considers whether there are sufficient incentives for shippers and pipeline owners to trade, and facilitate trade, of pipeline capacity.

There are a range of practical reasons why shippers might not look to sell unused pipeline capacity. Nevertheless, there *could be* incentives for shippers to "hoard" capacity and refuse

[5] http://apga.org.au/wp-content/uploads/2009/10/factsheet7-Economic-Regulation-110225.pdf

to sell spare that capacity to their downstream competitors. Our review will look at a number of elements that could address this type of potential market failure, for example by reducing transaction costs to make trading easier, or by reallocating unused capacity away from shippers.

We're also examining the regulatory frameworks in relation to the way the potential market power of pipeline owners is mitigated through regulation. There has been consolidation of pipeline ownership in recent times – potentially reducing competition – which makes this part of our review particularly relevant.

Currently, most gas pipelines are unregulated. Whether a pipeline is regulated is determined by a test in the National Gas Law.

The test is similar to the National Access Regime test which applies to a range of infrastructure across the economy, and appears to be designed to address issues that might arise in vertically integrated sectors.

However, the gas sector is vertically *disaggregated*, and so the test may not be particularly well suited to assessing the degree of competition in gas pipeline services. Part of our review will look at whether the current test is working - or if it needs to be changed to make it more gas industry-specific.

For the pipelines that are regulated, we need to assess if the regulations are working effectively – that is, if there are appropriate arrangements in place for shippers to gain access to those pipelines at a reasonable price with fair terms and conditions.

Another potential improvement to pipeline capacity trading is to increase the amount of information available to the market. This includes establishing the Bulletin Board as a one-stop shop for gas market data. We'll consider the long term role and function of the Bulletin Board - the type of data needed, the timeliness and reliability of that data, and how compliance with data provision requirements should be encouraged or enforced.

We are mindful that we need a coordinated approach to wholesale gas market design and the pipeline regulatory framework. They are interlinked - the east coast gas market is one system and requires a coherent set of arrangements to support the needs of consumers.

For example, larger virtual hubs, with a regulated entry-exit regime for allocating capacity, may be required if it is unlikely that a liquid, transparent and competitive market to trade pipeline capacity and hub services will develop.

Our recommendations on wholesale market design and our recommendations for pipelines regulatory frameworks are being developed together to increase the likelihood of more efficient market outcomes overall.

The last topic I'll cover is some general comments on trends in gas markets.

On the supply side, the Australian east coast gas market is one of the few energy markets in the world without substantial capacity overhang. The next six months will be telling as the LNG projects really ramp up. Some analysts have predicted that Australia will become the world's largest LNG exporter, ahead of Qatar, by 2020.[6]

While we can expect the global LNG market to continue to grow, the significant cost of new large LNG projects and tankers, along with increasing uncertainty in energy markets

[6] International Gas Union *World LNG Report* 2015 Edition

generally, may influence the speed and size of this development, making it difficult to predict the volume of Australia's LNG exports over the coming years.

Turning to the demand side: with the exception of the global financial crisis, growth in global gas demand in 2014 was the weakest in almost 20 years, following the downward trajectory of oil prices, slowing Chinese growth and European substitution of gas with renewables.

Looking locally, gas-fired electricity generation on Australia's east coast fell by nearly 8% in 2014/15 and domestic gas demand is expected to keep softening over the next few years.

Gas prices are likely to remain volatile – as you can see on the slide showing the gas supply hub daily price over the first half of this year.

What all this means is that it's extremely difficult to predict where demand and supply will end up for Australia's east coast, and we recognise this is a challenging environment for gas users.

High levels of uncertainty are not unique to the gas market. As I mentioned early, we see significant uncertainty as an ongoing feature electricity markets.

However, a lack of certainty about how the future may play out is not cause for alarm when our market frameworks are built on sound policy objectives, and when governance processes are in place for transparent and systematic review of market and regulatory outcomes.

Just as we do for electricity markets, we are focussed on developing gas market frameworks that are resilient and flexible, so they can adapt and allow a dynamic market response - and ultimately give gas users the flexibility they need to get gas in the most efficient way at the lowest possible cost.

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John Pierce
Chairman
Australian Energy Market Commission

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