



12 February 2016

Mr John Pierce
Chair, Australian Energy Market Commission
Level 6, 201 Elizabeth Street
Sydney NSW 2000

Submitted online via the AEMC website

Dear Mr Pierce

RE: East Coast Wholesale Gas Market and Pipeline Frameworks Review (GPR0003) and Review of the Victorian Declared Wholesale Gas Market (GPR0002)

ERM Power Limited (ERM Power) appreciates the opportunity to provide comments to the Australian Energy Market Commission (AEMC) on its Stage 2 Draft Discussion Papers listed above.

About ERM Power Limited

ERM Power Limited (ERM Power) is an Australian energy company that operates electricity generation and electricity sales businesses. Trading as ERM Business Energy and founded in 1980, we have grown to become the 4th largest electricity retailer in Australia, with operations in every state and the Australian Capital Territory. We are also licensed to sell electricity in several markets in the United States. In addition, in 2015 we commenced gas retailing to industrial and commercial customers in Victoria. We have equity interests in 497 megawatts of low emission, gas-fired peaking power stations in Western Australia and Queensland, both of which we operate.

ERM Power is a retail gas market participant in the Declared Wholesale Gas Market (DWGM), the Brisbane Short Term Trading Market (STTM) and the Wallumbilla Gas Supply Hub.

ERM Power supports the AEMC's proposed pathway for the future development of the market with respect to information provision and pipeline capacity trading (subject to our comments in this submission). The AEMC should prioritise these areas. We do not support the significant changes proposed to the DWGM as we have not seen any compelling evidence to suggest that the changes are warranted. We outline our position on each of the main reform components below.

1. Wholesale Gas Trading Markets

Northern Hub

ERM Power supports the AEMC's proposal to enhance the existing Wallumbilla Gas Supply Hub and establish it as a Northern Hub for wholesale gas trading. We also agree that the implementation of a Gas Supply Hub at Moomba and development of the Optional Hub Trading Services model are appropriate next steps and will provide participants with additional flexibility. With respect to the proposal to develop Wallumbilla into a single virtual trading zone, our view is that the market is still relatively immature and should be given some further time to operate to allow the needs of the market to emerge, prior to making any major changes that are likely to be costly and may ultimately prove to be misguided.

Southern Hub – comments on proposed changes to the DWGM

We do not support the AEMC's proposal to replace the existing DWGM trading arrangements with a system of voluntary, exchange based trading and exit/entry capacity rights. As recognised in the AEMC report, the DWGM is generally regarded as having met its original objectives of supporting retail competition and encouraging a diversity of supply and upstream competition in Victoria.¹ We agree with this view, although we consider that there are a few issues that should be addressed to ensure risks are manageable and allocated more equitably (we refer the AEMC to our earlier submissions²). There has also been no evidence to suggest that the existing regulatory process governing pipeline capacity investment in Victoria has led to inefficient investment and higher costs to consumers.

Given that the market has generally been functioning effectively, we question the need to completely overhaul the entire trading arrangements in Victoria. As ERM Power has stated in its earlier submissions, a logical next step would be to implement more targeted and incremental changes to address known issues within the current operating framework. The changes proposed by the AEMC are likely to entail significant costs of design and implementation, and require major system and process changes. We are also concerned that the proposed design will increase barriers to entry, adversely impact retail competition, and overall be a regressive step.

- *Reduced liquidity and barriers to entry*

Under the current DWGM arrangements, certainty of liquidity is enabled via the requirement for participants to submit bids and offers, with price being determined at the point at which demand meets supply. Participants have an incentive to submit competitively priced bids and offers to ensure they are scheduled to withdraw or supply gas, to the extent it is economic for them to do so. The current arrangements provide participants with certainty that they can source competitively and transparently priced gas from the pool. This is particularly valuable for new entrant retailers who may find it difficult to secure bilateral contracts for small quantities on competitive terms.

Under the proposed arrangements, a participant will no longer have this certainty. To meet any firm load commitments and manage its risks, a participant will be required to secure bilateral contracts, or otherwise be exposed to potentially punitive balancing costs if they are unable to secure sufficient gas from the voluntary exchange (we discuss our concerns with the AEMC's proposed approach to balancing further below). The proposed changes are therefore likely to reduce liquidity, create barriers to entry, and adversely impact retail gas competition.

- *Disproportionate risks and gaming opportunities*

The AEMC's proposed market design does not change the underlying physical characteristics and requirements of the system. Balancing, and the costs of managing balancing, will still be features of the market.

Under the current arrangements, intraday balancing is managed by the system operator, and priced at deviation prices (which are calculated transparently based on the market bid/offer

¹ AEMC, Review of the Victorian Declared Wholesale Gas Market, 4 December 2015, page ii, last paragraph.

² Refer to our earlier submissions to the AEMC dated 14 October 2015 (DWGM Discussion Paper), 11 September 2015 (Wholesale Markets Discussion Paper), and 26 March 2015 (East Coast Wholesale Gas Market and Pipeline Frameworks Review discussion paper).

stack). The ancillary payment/uplift regime addresses any intraday requirement for additional gas to deal with system constraints and unanticipated deviations.

The AEMC proposes that during the initial phase of the market when liquidity is still developing, the hub operator will purchase balancing gas from a balancing platform (into which participants submit bids and offers). If and when the exchange based market becomes sufficient liquid, the hub operator will purchase balancing gas from the exchange. The costs of balancing will be allocated to those who fail to “trade out their imbalance” within a period yet to be defined.

ERM Power questions the benefits of implementing this new model when the current arrangements already provide a mechanism for competitive market based balancing.³ In addition we have concerns that the proposed design will result in disproportionate risks imposed on small participants, as outlined below. Questions are also raised around the feasibility of the model.

- The risk of being out of balance is more likely to be experienced by new entrant retailers, who may find it difficult to secure flexible bilateral contracts and/or sufficient gas from the exchange in the precise quantities required.
- The parties who will be able to supply balancing gas, will be those who have the ability to nominate flexible supplies (such as LNG) on an intraday basis. These are likely to be the larger and more established players (as products such as LNG and storage may be uneconomic for a small participant due to high fixed costs). Larger players will therefore be more capable of offsetting any balancing costs that they may incur, with revenue received from the balancing market. Further, larger players with access to flexible gas supplies, will be more capable of correcting an imbalance that arises within the day, to minimise their exposure to balancing costs. Smaller participants are unlikely to be able to manage their exposure in this manner.
- Smaller retailers may have a higher degree of forecast error compared to their more established counterparts, as a small retailer will lack the benefits of load profile diversity that comes with a larger and varied customer base. This increases their exposure to balancing “cash out” prices.
- There appear to be potential gaming risks. For instance, consider the case where a sudden increase in demand during the day caused by a gas fired generator or a shipper exporting gas out of Victoria, leads to a sudden balancing gas requirement. This requirement might be to meet the additional demand as well as to maintain adequate pressure levels in the system. The hub operator purchases expensive balancing gas for a few hours of the day from the platform (noting that such gas could potentially be supplied by the same participant who caused the deviation). The same participant could then rectify its own imbalance with itself during the balancing period with its flexible supplies, shifting the cost incurred by the hub operator in purchasing balancing gas, to other participants who have failed to resolve their imbalance due to inability to secure sufficient supply.
- A consequence of all the above is that smaller participants are likely to wear the costs of any additional gas (costs of which are likely to be inflated) that needs to be purchased by the hub operator during a day to manage constraints or to maintain the system security.

³ The AEMC also notes in its Stage 2 DWGM report (page 13) that the DWGM is generally regarded by participants as “providing an effective and competitive gas balancing service and facilitating trading of gas in Victoria on short term prices.”

- *Other issues with balancing*

The AEMC's proposed design places the primary responsibility for balancing on market participants, with the hub operator playing only a residual role. We think that the importance of the role of the hub operator may have been underestimated in the context of the meshed Victorian transmission network, where there are physical constraints that need to be managed and flows that need to be centrally coordinated.

The AEMC proposes options for the selection of the balancing period. With respect to the proposed intraday (four hourly) and daily options, the AEMC's proposal to incentivise participants to balance themselves within the balancing period would require participants to have access to real time and accurate metering data that reports their actual position, and certainty that data will not be retrospectively changed. Under the current market arrangements, final positions are not known until 18 business days after the end of the month (and subject to revision thereafter). Allocation data would need to be provided at intervals consistent with the balancing period under the AEMC's proposed design, otherwise balancing risks will be unmanageable.

With respect to the "no specific balancing period" option where shippers' imbalance positions are relevant only if the system as a whole is out of balance, we are not clear how this proposal would work in practice, including how individual shipper imbalances would be closed out and settled. More detail is required for us to comment.

- *Capacity bookings under an entry-exit model*

The proposed entry/exit regime may lead to inefficient outcomes and potentially higher costs passed on to consumers, if retailers have to commit to exit rights for an extended period of time, despite their changing portfolio requirements arising from customer churn. Tied up exit rights may also lock out new entrants from the market if there are no additional exit rights available, although this risk could be reduced by the ability of the hub operator to sell additional short term rights. We note that under the current user-pays system (comprising volumetric tariffs rather than capacity tariffs), retailers/customers only pay when using the system and are not locked into fixed costs, and anyone can access the right to take gas out of the wholesale market.

- *Entry/exit system and signals for investment*

We are unclear as to how the proposed entry/exit regime will provide improved signals for investment in pipeline capacity, compared to the current arrangements, particularly given the meshed network and interdependent nature of capacity at various points in the system. The pricing of entry/exit rights is also likely to be complex. ERM Power is unconvinced that the proposed entry/exit regime will provide any materially different outcome compared to the current arrangements. As pointed out in our earlier submission, there has been no evidence that the current regulatory process for pipeline investment has led to inefficient outcomes, nor is there anything to suggest that the current regulatory process is likely to produce future deficient outcomes.

- *Proposed changes to DWGM do not facilitate trade between regions*

In ERM Power's view, the proposed arrangements will not make it any easier to move gas between Victoria and other locations. The ease at which gas can be moved between regions is fundamentally driven by the ability to access to pipeline capacity (appropriately addressed by the AEMC's proposals in this area). Even if the AEMC's pipeline capacity trading reforms are effective, the exit/entry model may in fact hinder the ability of participants to take advantage of

short term interregional trading opportunities if they have to secure the relevant capacity rights before they can move gas into or out of Victoria. Under the current arrangements, a participant with access to transportation rights on an interconnecting pipeline would only need to ensure that it is accredited to inject and withdraw at the relevant point and structure its bids and offers accordingly, in order to buy gas from or sell gas into Victoria (noting that AMDQ Credits will only be of value in the case where bids are tied and there is a limit on the total combined bid quantity that can be injected or withdrawn).

- *Reduced transparency*

The proposed design reduces the current transparency of valuable market information pertaining to prices/indicative costs, quantities, participant market shares, participant sources of contracted gas supply and demand, which are provided by bid stack data.

- *Meaningful market prices and the emergence of financial derivative products*

The AEMC asserts “a key benefit of transitioning the DWGM to a system of voluntary trading with market based balancing is the expected emergence of a reference price that encourages the development of financial derivative products”⁴

This comment implies a view that prices under the proposed design will be more meaningful than prices in the current DWGM, a statement with which we disagree. ERM Power’s view is that generally (other than where uplift costs are incurred) the current approach to setting price based on bids and offers, is efficient and produces pricing outcomes reflective of underlying short term demand/supply conditions. Under the proposed design, the separate balancing market may make it even more difficult for financial derivatives to emerge, given that participants will face two sets of prices.

Overall we see little benefit from the proposed changes and urge the AEMC to revisit its draft recommendations with a view to developing more incremental and targeted improvements.

STTM changes

ERM Power does not support the removal of the STTMs (or replacing the STTM with a balancing market) as we believe that such a move will create barriers to entry (as detailed in our earlier submissions). However we accept AEMC’s proposal to only consider changes to the STTM at a later time in the future, and proceed with changes only if the other reforms have led to sufficient trading liquidity.

2. Pipeline capacity

Capacity auction

ERM Power believes that there is merit in the AEMC’s proposal to auction contracted but un-nominated capacity on fully contracted pipelines, with a regulated reserve price on all pipelines. Such an approach has the potential to stimulate short term trades of capacity and enhance access to short term capacity in a non-discriminatory manner. The auction could also be extended to non-fully contracted pipelines.

To enable all shippers to participate in these auctions and trade capacity on any pipeline, there may need to be a registration process or a default GTA developed for each pipeline that will apply

⁴ AEMC, Review of the Victorian Declared Wholesale Gas Market, 4 December 2015, page 24.

to shippers who don't currently have a contract with the relevant pipeline operator. Such GTAs should have no minimum fees to minimise barriers to participation.

There should be no restriction on shippers (who have not nominated capacity on D-1) with respect to making intraday nominations or any nomination after the auction (which the pipeline operator should be able to support if there is still capacity available after the auction).

Capacity trading platforms

ERM Power supports the AEMC's recommendation to develop capacity trading platforms. However care will need to be taken to ensure that any transaction data reported does not reveal commercially sensitive information about the transacting shippers. On some pipelines, it is likely to be possible to deduce the identity of the transacting shippers based on details such as quantities and delivery points.

We do not think it is necessary to require all secondary capacity trades to occur through the platform, or to prohibit bare transfers. These restrictions act to limit the range of mechanisms available to the market to trade capacity. In addition, trades of capacity outside the platform may be part of a more intricate arrangement comprising multiple elements (e.g. capacity bundled with commodity, financial product, electricity product etc.). Requiring all trades of capacity to occur through the platform may suppress innovation in contracting strategies.

We would also be concerned if shippers were required to disclose details of all secondary trades occurring outside the platform. Pricing structures under more complex contractual arrangements could mean that any capacity price reported by the shipper would be subject to the shipper's discretionary interpretation, and hence may not be reliable or directly comparable with prices reported for more standard products traded on the platform. Further, mandatory disclosure of the terms and conditions of such arrangements could reveal commercially sensitive information about a shipper's strategies.

The auction process alone, with a regulated reserve price on all pipelines, may be sufficient to incentivise secondary capacity trading. A possible approach may be to implement the auction and regulated reserve price first, with the need for the other reforms being assessed at a later date.

3. Information and the Bulletin Board

ERM Power welcomes the suite of recommendations made by the AEMC in Chapter 6 of the Stage 2 East Coast Wholesale Gas Market and Pipeline Frameworks Review Draft Report, in relation to information provision, which are detailed in the AEMC's Stage 2 Draft Report: Information Provision ("Information Provision Report"). We believe that the AEMC recommendations will help to improve gas market transparency, ensure that information is made available on a more level playing field, and increase participants' ability to make informed and timely commercial and operational decisions.

ERM Power notes its support for broadening the purpose of the Bulletin Board in the gas rules, expanding its coverage to capture a wider range of information, implementing a requirement for changes to a facility's capacity during a day to be reported as soon as practicable, improving the reporting and compliance frameworks, and introducing a process for ensuring that the Bulletin Board remains updated to reflect the evolving needs of the market. We strongly agree with the recommendation that LNG processing facilities should be required to report their facility's short and medium term capacity outlook and material intraday changes in capacity.

As owner and operator of Oakey Power Station in Queensland, ERM Power will fall into the “large gas user” category. We support the principle of a transparent gas market, and accordingly do not have any issue with the proposals set out in Table 2.4 of the Information Provision Report relating to large gas users, that require disclosure of nameplate capacity ratings and delivery points, material changes to nameplate capacity, and actual daily consumption data on the day after the Gas Day.

With respect to the Commission’s questions 8, 9 and 10 in its Information Provision Report, ERM Power’s view is that NT and northern Queensland facilities should be captured if they become connected to the east coast gas market, for instance once the Jemena North East Interconnect is completed (or any other reason that makes it appropriate to include these facilities). We also consider it important for production and storage facilities that are located within a distribution network (e.g. AGL Newcastle Gas storage facility) to be captured (subject to meeting the relevant threshold criteria) since these facilities are connected to the rest of the market and their activities can impact on price/demand/supply conditions.

4. Next steps

ERM Power strongly recommends that the AEMC reconsiders its proposals relating to the DWGM and STTM for the reasons outlined in this submission. Any major market design changes proposed should also be supported by a cost benefit analysis that demonstrates net benefits. Modelling of the potential risk allocation impacts should also be undertaken to confirm that the changes will not create barriers to entry, reduce competition or increase costs to gas consumers.

As we have noted in an earlier submissions, the current AEMC advisory group was not formed on a transparent basis and is over represented by larger participants. Going forward, to ensure representation of all stakeholders on a level playing field, any working group established to guide the development of market reforms should be open to any interested industry participant.

Thank you again for the opportunity to provide input into this important review. Please feel free to contact me if you would like to discuss any of the points raised in our submission.

Yours sincerely

A handwritten signature in black ink, appearing to be "SK", written over a light blue circular background.

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