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Australian Energy Market Commission
PO Box A2449,
Sydney South NSW 1235

AEMC Strategic Priorities

Dear Mr Pierce,

Thank you for the opportunity to comment on the AEMC Strategic Priorities. Please find attached our submission which focusses on what we consider the most important priority, namely, an effective gas market in Australia.

If you have any questions in relation to this submission or would like some additional information, please contact David Bowker on 03-62305775.

Yours sincerely,



Evangelista Albertini
Acting Chief Executive Officer

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Hydro Tasmania Submission on AEMC Strategic Priorities

1 Executive summary

Hydro Tasmania strongly supports initiatives to include gas market development as a priority of the Australian Energy Market Commission (AEMC). Hydro Tasmania considers that gas market development to date has delivered significant improvements in the ability to trade gas in the short term through the Short Term Trading hubs (STTHs), the Victorian Declared Wholesale Market and the possible brokerage trading hub at Wallumbilla. Each of these existing arrangements provides some assistance to longer term contracting through daily price discovery and by facilitating operating efficiency.

However, the process to develop gas supply contracts, is time consuming and costly. Price discovery is poor. This situation is consistent with a tightly held bilateral market environment but not well suited to development of a broader and more diverse participant base. In years to come the trading hubs, or yet to be developed financial exchange platforms, may be the principal means for trading, but for the foreseeable future Hydro Tasmania expects bilateral contracts to be a fundamental trading instrument.

Accordingly Hydro Tasmania considers that bilateral contract formation can be more efficient and effective than at present and that initially greater focus is required on facilitation of long term contract formation.

Objectives for a mechanism to enhance long term contracting should be:

- Market based wherever possible – consistent with the Commonwealth Government’s draft Energy White Paper;
- Facilitate efficient investment in gas supply and haulage;
- Complement existing and developing short term trading and market mechanisms;
- Cost effective.

A mechanism is suggested in this paper that would:

- Provide more timely and efficient facilitation of gas supply contracts for delivery at nominated points – generally the existing trading hubs;
- Be optional – subject to review.

2 Gas Market Reform

The Australian Energy Market Commission (AEMC) is developing its “Strategic Priorities for Energy Market Development” for 2012 and has invited submissions from stakeholders. The following excerpts from the AEMC strategy documents highlight that there is a growing recognition for the need for gas market reform and that this should be a priority of the AEMC.

Hydro Tasmania was very pleased to see that in the 2011 version of this document the AEMC had highlighted¹:

“...a significant proportion of respondents considered that more emphasis was required on the emerging challenges in the east coast gas market. Stakeholders believed that the implications of the likely linkage between east coast gas prices and international prices for the Australian electricity market was not well understood by policy makers. There was also a concern that arrangements to address security of supply and emergencies in the gas and electricity markets were not well coordinated.”

The document added that:

“...the AEMC will be engaging further with stakeholders and undertaking research and analysis to consider the scope for more detailed work on these issues. However, we are keen to avoid duplication with existing planned work, including AEMO’s reviews of Short Term Trading Market (STTM).”

The paper went on to outline that one of the issues for future consideration was the gas market and its interaction with the National Electricity Market (NEM). This section outlined the approach being taken by the AEMC as outlined above to monitor and understand how the STTM market systems develop. But there was an acknowledgement of the issue raised by stakeholders (6 or 7 quoted) of further gas market development (pp. 35):

“However, several stakeholders considered that substantial further development of the gas market is required as the growth in gas fired generation increase convergence between gas and electricity markets.

This was focused on gas supply security and that there was no ability for a market operator to:

“...direct gas producers at times of supply shortage or system events.”

Other stakeholders noted that:

“...it will be important to facilitate the development of liquid and transparent gas markets in the future to enable parties, including electricity generators, to efficiently manage their gas contracting and trading risks”

Others noted that:

¹ Strategic Priorities for Energy Market Development, AEMC, 2011

“...the AEMC should further consider how the impact of increasing gas demand for electricity generation can be met through investment and operation of the gas transmission framework....this could include reviewing issues such as congestion and access to transmission capacity and information transparency.”

It was pleasing to see that the AEMC/AERI Public Forum contained a paper² examining the proposition that:

“We recognise that there are, and should be, a range of reform priorities across the competitive energy markets and related regulated service provision.....and that gas market reform should be one of those strategic priorities”

The paper started to explore the concept of having gas supply hubs and access to pipeline capacity being more flexible with the guiding principle:

“Gas market participants should be able to freely trade between pipelines, regions and basins.”

This paper also acknowledged that gas is one of the key transition fuels to a lower carbon future and that projections show that gas and wind could be key generation sources in coming decades. It concluded with the same view that Hydro Tasmania holds:

“Gas market reform should be one of the strategic priorities (for AEMC)”

The issues noted by stakeholders and in part reflected in AEMC discussion fall into two broad groups. The first relates to continued refinement of the short term operation and trading (via the Victorian market, STTM hubs and the possible Wallumbilla brokerage hub), the second deals with longer term issues relating to ability to arrange long term supply and transport, which is the starting point for short term trading.

Hydro Tasmania strongly agrees with the need to enhance arrangements in both short and long term horizons. The focus of this submission is on the need for a more transparent and liquid gas market on the east coast of Australia for long term investment. Better long term arrangements will deliver improved efficiency in securing and using gas for electricity generation and retail market competition.

2.1 Gas Supply

Long term arrangements for purchase (and transport) of gas is based on bi-lateral contracting – there is limited access to gas trading except short term trading at balancing hubs and markets.

Liquidity of gas supply contracts and ease of well head/market price discovery is controlled largely by the major gas producers with very limited involvement of wholesale gas traders standing in the market. The STTM and Victorian gas market structures do provide some level of price discovery but these tend to reflect on-the-day balancing issues rather than being indicative of longer term gas supply costs. In principle, future contracts may contain more cost reflective incremental costs but there has been little incentive for this approach under

the current bi-lateral market system where cost structures have been negotiated and linked to matters such as take or pay volumes.

Our experience is that small and emerging gas producers also find it difficult to access the downstream gas market efficiently because of the bi-lateral contracting structure, which is more suited to large volume transactions. As a result they often elect to sell their off take to one of the major gas producers for them to on-market their supply. Authorised marketing or joint venture sales arrangements also continue to be prevalent, even in the more mature arrangements on the east coast.

While concern has been expressed by some stakeholders that gas supply restrictions exist currently in the upstream market due to the demand from the LNG sector³ and this will force prices up, in our view this has over the last couple of years been yet to materialise as it has for example in Western Australia. Gas suppliers generally make the point that more gas is available at a price – which they set in a bi-lateral agreement.

Experience in that period has shown though that when sufficient competitive pressure can be brought to bear between suppliers of gas (producers and wholesalers) more competitive outcomes arise, but that this is a problematic process requiring a great deal of expertise and cost to reach that point.

In our view the process of securing gas supply is quite inefficient and has very high transaction costs. We are aware of cases where new entrants seeking to purchase substantial volumes of gas face a lengthy process to engage with the major producers on gas supply arrangements in any meaningful way.

Economically this is creating lost opportunities and arguably inefficient investments and dead weight loss across the energy market. It also favours the larger vertically integrated energy companies (in fact provides a very positive incentive for this integration) and it is telling that all the major retailers in Australia have some form of equity gas positions upstream now and continue to develop these positions.

This means that access to suitable gas supply products for new market entrant retailers is very limited or non-existent and the ability to back a power station with a bankable gas supply contract is equally extremely difficult to access as a new entrant or even for existing key developers who do not have large gas portfolios or equity gas positions.

3 The AEMO as part of its 2012 Gas SOO analysis commissioned a review of Eastern and Southern

Australia Gas Reserves and Resources to support the development of the modelling inputs for the Gas SOO. AEMO stated “This analysis indicates that there are sufficient reserves and resources to satisfy projected gas demand for the next forty years under all scenarios (see below for scenario descriptions). However, this analysis assumes that reserves are developed in a timely manner and are available to the market when required. As conventional resources are depleted or used in the LNG export market, CSG or unconventional gas reserves will have to be utilised within the domestic market. This, combined with a large proportion of reserves committed or earmarked for LNG projects, may create challenges for domestic supply and increase the cost of gas for users.”

It is becoming very clear to us that the current bi-lateral contracting process for acquiring wholesale gas is in need of reform and the AEMC needs to play the lead role in that reform agenda.

2.2 Gas Transmission

We support views from a number of stakeholders that gas transmission assets will play a key role in development of gas supply, the ability to access capacity and to trade gas across basins and market hubs, as the demand for gas grows in the power sector.

These assets have various levels of regulatory oversight (very limited through to full coverage), and access to tariffs and information is generally good – complemented well by the Gas Bulletin Board. We would also note that innovation in tariffs is occurring slowly but positively.

Of some concern though is the contraction over the last couple of years in the ownership of gas transmission systems on the east coast – now set to be dominated by two key groups (APA Group and Jemena) and what impact this may have over time on prices and contractual conditions.

The other major concern is how to stimulate investments in new pipelines and expansion of existing systems? This has been traditionally through the larger shippers committing to long term bi-lateral agreements with private sector owners and operators, although there have been some small moves to build capacity on the basis growth will occur in shipping.

More broadly we note that in the current environment where overall demand has the potential to grow rapidly sub-optimal investment in supply may rapidly be swamped by the need for major growth. However, pipeline investments are generally fewer and are long lasting. Decisions about location impact their costs and regional development choices for many years, further underlining the importance of efficient pipeline investment decisions.

2.2.1 Victorian Gas Market

In the Victorian Declared Transmission System (DTS), which is covered by a market carriage system operated by AEMO (Victorian Declared Wholesale Gas Market - DWGM) and regulated by AER, the ability for gas power generation (GPG) in particular to secure transmission carriage that is firm is virtually non-existent.

New GPG is seen as non-firm in this system and in any case there is limited access to Authorised Maximum Daily Quantities (AMDDQ) required to provide some degree of hedging against the risks and costs of major gas congestion events (typically where LNG needs to be injected for system support). So this non-firm approach tends to be a circular argument in that it has to be interruptible to both assist manage demand constraints and to avoid high market costs that may arise from those constraints without hedge capability.

For GPG to potentially secure new transmission capacity firm is also problematic as the revenue (and capital expenditure) forecasts for the (monopoly) system must be approved by the AER and yet the market itself (which includes AMDDQ) is a market carriage model operationally and auctions AMDDQ.

The DTS owner must get AER approval for forecasts of GPG growth both for setting its price paths and capital expenditure forecasts. This often conflicts with AEMO forecasts of GPG on

this system as we understand the owner (APA GasNet) does get approaches for power station developments but is unable at the time to assure them of any firm haulage capacity for their gas supply.⁴ They must also factor in the potential for new developments based on policy settings, such as for carbon emission penalties, because these are 5 year determinations (and typically the forecasts are prepared a year before that new regulatory period starts).

Constraint pricing in the DWGM provides a market based pricing signal for the addition of capacity to the system. While additional transport capacity has been added as new supply basins have come on-line it is not clear that the additions to the regulated pipeline system have been driven by market pricing. Capacity expansion due to GPG driven demand remains problematic due largely it seems to the regulatory interactions involved.

This convoluted system demonstrates that in developing approaches to a more liquid and competitive wholesale trading market for gas regard must also be given to other regulatory imposts on the transmission systems (where for example they are still covered by full regulation as they are considered not to be part of a competitive market) and the ability to develop transmission capacity with less regulatory intervention.

2.3 Case for change to the status quo

STTM trading hubs, the Victorian DWGM and the possible brokerage hub at Wallumbilla provide valuable short term trading opportunities. However, all (effectively) require that participants bring established longer term contracts for supply and transport to market.

These arrangements must be developed on a bilateral basis and in the case of regulated pipelines in accordance with regulatory requirements that are not well suited to commercial development of new entrants.

Liquidity of contracts for new entrants, especially for small volumes, is low and negotiation processes are time consuming, costly, and with poor price discovery. This situation is consistent with a tightly held bilateral market environment but not well suited to development of broader and more diverse participant base.

3 Light on the (first) hill

3.1 Introduction

In this submission Hydro Tasmania is arguing that improvements are warranted to facilitate longer term contract formation to complement existing and emerging short term trading and brokerage arrangements.

We do this by first suggesting high level objectives – a light on the hill - and then proposing a possible direction for development of a pragmatic mechanism to support long term supply and transport arrangements.

4

Based on (commercially confidential) experience from negotiations in relation to possible new GPG projects

The mechanism is intended to function as a long term “front end” to the existing short term trading arrangements. The description of the mechanism presented is designed to initiate discussion and demonstrate that relatively simple additions to existing arrangements are feasible and valuable.

A key point to note is that the mechanism is premised on continuation of longer term bilateral contracts as the fundamental commercial instrument for trading of gas for some time. This does not rule out a progressive shift to spot trading or exchange trading through one of the shorter term markets in due course, but does not rely on it and does not require lengthy development time. This is important as we see an urgent need for improvement in environment for new suppliers and new demands.

When considering our approach we have noted that a recent article in the Economist observed that liquid short term trading in the US took years to develop and was associated with a glut of supply.⁵ The same article noted that European trading is in flux with questions around market pricing versus contract pricing and whether a linkage to oil price remains appropriate. Exchange trading is growing but still evolving and is well illustrated in work published on the Florence School of Regulation prepared by Oxford Institute of Energy Studies.⁶ Our view is that the Australian gas sector is some way from being able to rely on short term/spot or exchange trading for any significant volume and will be based on bilateral contracts for some time – at the same time the existing trading hubs provide the basis for a market led shift over time. However, as noted the focus of this submission is on improving the environment for long term contracting in the near-term – *and this is the light on the first hill.*

In the future, greater volumes and more participants may create conditions where a more sophisticated exchange, based on either physical or financial trading, will emerge or all gas will be transacted exclusively on the basis of short term trading hubs mechanisms meaning that long term contracts become less important. International experience will be instructive in this regard. Accordingly medium term developments should strive to retain flexibility – *or we should recognise that the second hill may only be evident when we reach the summit of the first.*

3.2 Objectives

- Adopt policy choice for market based decisions wherever possible – we see this as entirely consistent with the Commonwealth Government’s draft Energy White Paper – see for example the highlights box of Chapter 6B;
- The gas market should facilitate efficient investment in gas supply and haulage;
- The gas market should provide a contracting time frame suitable to integrate with other short term trading and market mechanisms; and
- At a practical level the gas market should facilitate the formation of an efficient sector-wide portfolio of bilateral contracts that experience is showing cannot practically be formed by the growing number of parties seeking supply.

5 <http://www.economist.com/node/21558433> - accessed 27 September 2012

6 http://www.florence-school.eu/portal/page/portal/FSR_HOME/ENERGY/Training/Specialized_training/Presentations/1.%20P.%20HEAT_HER%20-%202012.pdf - accessed 27 September 2012

4 Pragmatic direction for change

4.1 Overlay long term bilateral contract facilitation mechanism

We envisage a mechanism that would form a front end to the existing and developing short term arrangements. The mechanism would essentially be designed to facilitate the more timely, efficient and competitive formation of bilateral agreements – it would not be a trading mechanism as such.

An important requirement is that the mechanism be consistent with the STTM and emerging brokerage concept. Accordingly it will presume that transactions are to occur at defined hubs meaning shippers/pipeline owners would be jointly involved or have commercial responsibility for delivery to hub – although one player may lead but have a clear driver for joint arrangement. It would mean that purchasers need not be accountable for arranging transport – the offer would be for a bi-lateral gas supply agreement for gas delivered to, and settled at the hub.

In the Victorian DTS the equivalent to a transport agreement is that participants need to acquire AMDQ and this will require separate consideration to accommodate the relevant regulatory arrangements but in principle should deliver the same outcome, that is an assurance of ability to deliver or acquire gas to or from market over the longer term.

Participation would be optional as purely bilateral agreements could continue if desired providing these were in accord with short term operational requirements at the relevant hub. However, it would be expected that both sellers and purchasers would wish to at least compare prices available on a centralised process before locking in a long term contract.

We considered whether participation should be mandatory but for the following reasons feel that is not appropriate:

- Potential purchasers will have an incentive to post their interest in purchasing gas in order to seek a range of potential suppliers and prices, regardless of whether they are likely to deal with just one party in the end;
- Sellers may find interest in greater or earlier levels of demand by posting availability of supply more flexibly;
- Mandatory participation will unavoidably require use of standard contract forms which will inhibit innovation and flexibility in both supply and transport and therefore risk inefficiency;
- Optional participation is more compatible with the (private) ownership of most assets involved; and
- It is a logical transition from the current bi-lateral market and the short term trading market designs.

However, a material imbalance in supply and purchase offers would be a basis to review whether entirely optional participation is adequate.

4.2 Platform and contract form

We have not yet considered the detailed form of the platform but we would expect some form of centralised platform or information (bulletin) board in the first instance. We would also expect the platform to be simpler than a short term trading mechanism as daily balancing and market services would not need to be covered – simply the purchase of gas supply to present to the short term arrangement at the hub.

A centralised platform implies a degree of standardisation of contract forms, but the final agreement will be bilateral and can take whatever form the parties elect subject only to compatibility with subsequent short term trading.

However, we note that the concept is also consistent with shippers sourcing from multiple points in a portfolio as this will be a matter between shippers and pipeline owners.

Shippers and pipeline owners will no doubt need minimum volumes for initial or augmented capacity which in a bilateral only environment comes from large foundation customers and then large volume deals. Periodic closing of submissions may therefore be necessary. For example the platform might close each [6 or 12] months – effectively a rolling Open Season approach used in international circumstances.

4.3 Compatibility with electricity

Fixing the delivery point as one of the hubs where a short term/dispatch market operates is conceptually similar to the electricity market with generator access rights and we note current initiatives by the AEMC include consideration of access rights.

Separately Hydro Tasmania is expressing strong concern about the particular approach being proposed by the AEMC in relation to access in electricity. However, Hydro Tasmania considers that where it is feasible alignment between gas and electricity is valuable where incentives and regulatory design can be aligned and thereby reduce overhead of participants.

4.4 Value add

Together with the short term trading platforms a longer term hub based contracting platform should be conducive to the shippers and pipeline businesses working together to develop greater flexibility within their contract arrangements and for sale within short term trading hubs. It will also provide direct market access for smaller producers and others who want to potentially trade existing contracts or wholesale gas positions, and facilitate the demand side participants far more efficiently.

4.5 Governance/regulatory process

At this early stage we have not considered which regulatory instruments (e.g. National Gas Rules, National Gas Law etc.) would be the best and most appropriate instruments to implement enhanced arrangements. Clearly this would be a matter that would need to be considered as the proposal is developed.

5 Summary

In summary, Hydro Tasmania strongly supports initiatives to include gas market development as a priority of the Australian Energy Market Commission (AEMC). Hydro Tasmania considers that gas market development to date has delivered significant improvements in the ability to trade gas in the short term through the Short Term Trading hubs (STTHs), the Victorian Declared Wholesale Market and the possible brokerage trading hub at Wallumbilla. Each of these existing arrangements provides some assistance to longer term contracting through daily price discovery and by facilitating operating efficiency.

However, the process to develop gas supply contracts, is time consuming and costly. Price discovery is poor. This situation is consistent with a tightly held bilateral market environment but not well suited to development of a broader and more diverse participant base. In years to come the trading hubs, or yet to be developed financial exchange platforms, may be the principal means for trading, but for the foreseeable future Hydro Tasmania expects bilateral contracts to be a fundamental trading instrument.

Accordingly, as we have discussed, bilateral contract formation can be more efficient and effective than at present and, in the short term, greater focus is required on the facilitation of long term contract formation.