

Australian Energy Market Commission
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Review of the Victorian Declared Wholesale Gas Market (GRP0002)

The Australian Energy Council (the Energy Council) welcomes the opportunity to make a submission to the Australian Energy Market Commission (AEMC) on the Review of the Victorian Declared Wholesale Gas Market Draft Final Report (the Final Report).

The Energy Council is the industry body representing 21 electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. These businesses collectively generate the overwhelming majority of electricity in Australia and sell gas and electricity to over 10 million homes and businesses.

COAG EC Gas Vision

The AEMC has an important role to play in defining the strategic direction for gas market development that is consistent with the COAG Energy Council's (COAG EC) Australian gas market vision. A critical element of the gas market vision is the development of a long-term strategy for the design and location of facilitated trading markets.

A long-term strategy should include the whole East Coast gas market framework including, the Victorian Declared Wholesale Gas Market (DWGM). We support the principle of Recommendation 5 that the COAG EC task the Gas Market Reform Group (GMRG) to consider the AEMC's recommended reforms to the DWGM. However, the GMRG's scope of work should not be limited to implementing the AEMC's proposal, but also assessing the merits of the proposal relative to alternative options. Reforms to the DWGM are part of the broader COAG EC agenda to meet the vision for Australia's gas markets, and changes in one part of the market will impact progress toward the vision.

"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 opportunities¹."

The Energy Council agrees that the AEMC have identified the appropriate objectives for gas market development. While the DWGM has functioned for over 15 years, there is a need to ensure that it remains fit

¹ COAG Energy Council, 2014, COAG Energy Council Australian gas market vision, <http://coagenergycouncil.gov.au/publications/coag-energy-council-australian-gas-market-vision>

for purpose over time, and that market participants are able to manage their risks in an evolving environment. The market should continue to be improved over time to provide efficient outcomes for consumers.

Uncertainty about whether the Southern Hub reforms will deliver the targeted outcomes

The review has not provided an opportunity for an evaluation of the AEMC's proposed model against other alternative models.² The significant costs of the proposed reforms, estimated by PWC to be in the range of \$58m to \$480m by 2040 have not been compared to the cost of alternative reforms. The Energy Council is unable to conclude that the AEMC's proposed design is the most effective and efficient means of achieving the COAG EC's desired objectives. The Southern Hub model could actually introduce barriers to trade relative to the existing framework.

Changing the market framework may not lead to more efficient outcomes in the absence of changes to the underlying market structure of supply and demand. While moving to a model that makes it easier to trade gas between regions is an important development goal, Australia's domestic gas market fundamentals may not give rise to the drivers of a liquid market. Modest gas demand growth in the southern regions, coupled with an unlikely outlook for increasing supply in the near term (due to moratoriums on gas exploration) raise the question of the value of fundamental market redesign and the ability for market participants to create a deep and liquid market.

If the voluntary exchange based market proposed is illiquid, the reference price will not be credible and result in a low probability that an effective financial derivative market will develop. The absence of a credible reference price, and the removal of the mandatory gross pool, will make it more difficult for small players to access and negotiate supply. Under the proposed Southern Hub model it will be more costly and complex for participants to manage their position due to the need to align commodity purchases with the purchase of entry or exit rights. Costs are likely to be higher than under the current model, because participants may need to contract and pay for entry and exit rights on a fixed term basis, even if they do not use those rights every day. For the same reasons, it will also be more costly and complex to buy (or sell) gas from (or to) Victoria increasing the risk of trades moving off-market and low liquidity in the voluntary market.

There should be a clear and robust net benefit for proposed reforms to the market. AEMO's market participant list shows that a number of small participants including Dodo, ERM, Powershop and Click Energy, have recently entered the market. The entry of new market participants is evidence that barriers to entry under the current arrangements are low. The 2016 Retail Competition Review, undertaken by the AEMC, also noted that competition in the retail gas market in Victoria is stronger than in other jurisdictions. The net benefits of the proposed changes should be considered carefully, including through cost benefit analysis which compares design options. The disruption of transitioning this established market is likely to be significant for participants. The impacts on participants differ when designing arrangements at market start (such as in the Northern Hub) as opposed to transitioning a mature market to a completely new framework (such as proposed for the Southern Hub).

Learning from observation at the Northern Hub

While the Energy Council understands the aim of the proposed changes to increase liquidity and improve risk management by replicating a Northern Hub model in the South, the evidence of improved liquidity and contracting is yet to emerge in the Northern Hub. The Wallumbilla Gas Supply Hub has operated for nearly three years but generally only a few trades are made each day, and longer-term products (weekly or monthly) are rarely traded on the exchange at all. There are a range of commercially rational reasons why participants might prefer to trade off market, including the ability to tailor terms of bespoke deals. However, the lack of volume and depth of trading at the Northern Hub is indicative of the risk to redesigning the Southern Hub under a similar model. Financial derivative markets will not develop if the exchange based market for the underlying

² We acknowledge that in the AEMC's Discussion Paper dated 10/09/15, the AEMC put forward five high level reform packages, including a Package A comprising a set of "Targeted Measures" that comprised incremental improvements to the existing market design. In the consultation process there was little support expressed for Package A. However this response is likely to be reflective of a lack of support for the specific incremental changes proposed, rather than a desire to unwind the whole market. Further, it was very early in the process and none of the packages had been socialised with industry. In addition, at this stage, none of the packages included the proposed Southern Hub model.

physical product is illiquid and participants do not have confidence in the reference price. By observing the lessons from the Northern Hub, any improvement in the Southern Hub can be implemented to achieve the most efficient outcome.

The transition

The transition process is very important to our members because many have existing contracts which will be affected by the proposed changes to market design. The Energy Council is concerned about proposals which may extinguish existing contractual rights without providing adequate compensation. For example, we are concerned that the proposal for a day-ahead auction for contracted but un-nominated capacity may inadvertently reduce the ability for gas fired generators to re-nominate on the gas day. This will significantly affect the flexibility of these generators in the electricity market. Market participants are also very concerned about the value of authorised maximum daily quantity (AMDQ) credit certificates and compensation for the loss of this value under new arrangements.

Way forward

We believe that there should be an additional step in the process that involves an evaluation of feasible alternatives prior to deciding on the particular reform pathway. An alternative pathway that builds upon the existing market framework, preserving or enhancing the strengths of the current market and addressing its weaknesses would mitigate the costs and risks associated with changing an established market. A set of reforms that builds upon the current arrangements rather than dismantling them altogether, is likely to be a less risky and costly approach.

Prior to any decision on the way forward, the review should allow for the following (which could be undertaken under the direction of the Gas Reform Group):

- Consideration of the concerns raised by industry with respect to the AEMC's proposed reforms.
- An analysis of how the current market design could be enhanced to more effectively meet the COAG Energy Council objectives.
- An evaluation of the market design options, taking into account the relative cost and benefits.

Summary

The Energy Council is supportive of simplification and improved flexibility and transparency in the DWGM. Our concern is that the substantial changes proposed will introduce new complexity and require significant, costly changes to systems and existing trading arrangements, which will ultimately be passed on to consumers. These costs should be carefully weighed against the benefits in determining the most effective way to improve the operation of the market.

Any questions about our submission should be addressed to Emma Richardson, Policy Adviser by email to emma.richardson@energycouncil.com.au or by telephone on (03) 9205 3103.

Yours sincerely,



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