

ERM Power Submission to the AEMC's Final Draft Report on the Review of the DWGM of Victoria – Executive Summary

ERM Power does not support the AEMC's proposed changes to the DWGM. **There is a significant risk that the proposed changes will create barriers to entry, reduce competition, and increase costs for gas consumers.**

Issues with the AEMC's proposed Southern Hub model

- There is a risk of low liquidity under a voluntary trading regime.
- A reference price based on an illiquid market will not be credible, reducing the likelihood that a market for financial derivatives will emerge.
- The removal of the gross pool will result in a significant loss of transparency of key market information, creating barriers to entry and making it harder for small players to compete.
- Relying on a voluntary market comprising a limited number of sellers, to meet market balancing requirements, gives rise to the potential for gaming opportunities and higher balancing costs. Small participants will face unmanageable risks.
- The requirement to align entry/exit rights with supply purchases and load will increase portfolio management costs and erode flexibility. It will be more costly and complex to adjust the intraday position.

The above points are elaborated on in our submission.

Evaluation process needs to include an assessment against alternatives

- The current market, while not being perfect, has operated well and enabled strong retail gas competition in Victoria. To justify a move to a completely different model, there needs to be a high level of certainty that the changes will deliver the benefits being sought, and do so more effectively and efficiently than the alternatives.
- For the reasons described in our submission, there is a significant risk that the proposed Southern Hub model will not achieve the desired market outcomes.
- The review process has not assessed the proposed Southern Hub model against any alternative. This should be done given the significant nature of the reforms and the high implementation costs (estimated by PWC to be nearly 70% of the cost of entire east coast gas market reform package – with total costs to 2040 of up to \$480 million).
- The Gas Market Reform Group should consider the potential for alternative models to achieve the policy objectives. In particular there should be analysis of how the current arrangements could be enhanced to more effectively meet the COAG Energy Council vision.



2 December 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: Draft Final Report – Review of the Victorian Declared Wholesale Gas Market (GPR0002)

ERM Power Limited (ERM Power) appreciates the opportunity to provide comments on the Australian Energy Market Commission (AEMC)'s Draft Final Report on the Victorian Declared Wholesale Gas Market.

About ERM Power

ERM Power is an Australian energy company operating electricity sales, generation and energy solutions businesses. The Company has grown to become the second largest electricity provider to commercial businesses and industrials in Australia by load¹, with operations in every state and the Australian Capital Territory. A growing range of energy solutions products and services are being delivered, including lighting and energy efficiency software and data analytics, to the Company's existing and new customer base. ERM Power also sells electricity in several markets in the United States. The Company operates 497 megawatts of low emission, gas-fired peaking power stations in Western Australia and Queensland.

ERM Power is a gas retailer in the Declared Wholesale Gas Market of Victoria (DWGM), a shipper in the Brisbane and Sydney Short Term Trading Markets and a trading participant at the Wallumbilla Gas Supply Hub.

Comments on the Draft Final Report

ERM Power has significant concerns that the AEMC's proposed changes to the Victorian DWGM will not deliver the benefits being sought and that the removal of the existing open access, mandatory gross pool arrangements will create barriers to entry and reduce competition. We maintain the position presented in our earlier submissions², noting that the AEMC's proposals have remained largely unchanged since the initial recommendations were released in December 2015, despite the concerns raised since then by ourselves and other industry stakeholders.

Evaluation process and justification for the way forward

The review has not provided an opportunity for an evaluation of the AEMC's proposed model against any other alternative model.³ Without such an assessment, and notwithstanding the specific concerns

¹ Based on ERM Power analysis of latest published financial information.

² ERM Power submissions dated 12/02/16 and 29/03/16 lodged in response to the AEMC Draft Report and Discussion Paper.

³ 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

we have with the AEMC's proposals, it is not possible to conclude that the AEMC's proposed model would be the most effective and economic way of achieving the desired policy objectives.

Given the significant costs of the AEMC proposed reforms, estimated by PWC to be in the range of \$58m to \$480m by 2040⁴, 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 would be worth considering is one that builds upon the existing market framework, preserving or enhancing the strengths of the current market and addressing its weaknesses. A reform pathway that builds upon the current arrangements rather than dismantling them altogether, is likely to be a less costly approach, and its benefits more certain given that we would be starting with a proven working model. We refer to the attached independent report prepared by Seed Advisory that identifies the elements of the existing market that would be worth retaining and opportunities for improvement, and recommends an alternative way forward that does not involve unwinding the entire current market arrangements.⁵ This recommendation accords with ERM Power's preferred way forward. The report also identifies some significant issues with the AEMC proposal.

It is also misleading to conclude, based on the PWC cost benefit analysis, that *"implementing the Southern Hub arrangements would result in tangible gains for the Australian economy"*.⁶ While the PWC analysis showed the potential for net benefits, those net benefits are based on an assumed set of market outcomes being realised.⁷ The PWC analysis does not consider how likely it is that the proposed Southern Hub arrangements will deliver those outcomes. As we describe in our submission, there are a range of factors that make it highly uncertain that the proposed Southern Hub model will deliver the benefits as assumed in the cost benefit analysis. The PWC findings however usefully demonstrate the potential gains to the economy that could be delivered by an effective set of reforms (which may not necessarily be the Southern Hub proposal), including through potentially lower cost changes that build upon the existing market arrangements.

We elaborate on our specific concerns with the AEMC's proposals below.

Issues with the AEMC's proposed reforms

Removal of the mandatory gross pool will create barriers to entry

ERM Power is concerned that the replacement of the current gross pool arrangements with voluntary exchange based trading, will lead to the bulk of trading going off market, result in low liquidity on the exchange and a significant amount of transparency being lost. If the voluntary exchange is illiquid, the benchmark/reference price will not be credible. This will make it even more difficult for small players

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.

⁴ PWC, Cost benefit analysis of the Victorian Declared Wholesale Gas Market, Final Report, October 2016, page vii.

⁵ Seed Advisory, "Declared Wholesale Gas Market Review – Report for Victorian Gas Market Participants", 2/12/16. This report was commissioned by and developed in consultation with a group of Victorian gas market participants who operate in multiple markets across the eastern seaboard (Origin, AGL, EA, Gas Trading Australia, M2, Engie and ERM).

⁶ AEMC Final Draft Report, Review of the Victorian Declared Wholesale Gas Market, 14/10/16, pg vi.

⁷ The benefits estimated by PWC represent the gains to the economy from a specific set of assumed outcomes including "increased market efficiency", "greater ability of firms to manage risk", "lower transaction costs", "lower barriers to entry", and "greater access to available gas/security of supply" (pg 9 of PWC Cost benefit analysis of the Victorian Declared Wholesale Gas Market, Final Report, October 2016).

to access gas or negotiate for supply, and reduce the likelihood that an effective financial derivative market will emerge.

The Queensland experience should be considered. The Gas Supply Hub (GSH) at Wallumbilla is located at the point of intersection of three major gas transmission pipelines, connected to major gas fields, storage facilities and demand sites, and a hub at which a large number of players operate (including the LNG participants). Taking all these factors into account, in theory, the Wallumbilla GSH should represent a natural position to foster deep and diverse trading outcomes. Despite the Wallumbilla GSH natural advantages and the significant quantities of gas that flow through Wallumbilla, since the commencement of the GSH in March 2014 there has only been an average of 2 trades per day with longer dated products rarely being traded on the exchange⁸. In our view, this relatively low number of trades on the exchange is reflective of a preference by market participants to transact off market and/or to retain flexibility in their supply arrangements to manage their own position or support future trades (given that gas can be stored), rather than a result of the separation of the trading locations as some parties have suggested.⁹ Similarly, there have been no trades at Moomba since the GSH was introduced there in June 2016.

There are a range of commercially rational reasons why participants might prefer to trade off market, including to tailor the terms of bespoke deals, keep their trades and implied positions undisclosed, to create an information asymmetry in order to gain a competitive advantage, or in a market where there are a small number of players, to deliberately impact (or not impact) the published/benchmark price (e.g. a long participant who sells some gas at a relatively low price may prefer to undertake the transaction bilaterally to avoid depressing the prices on the exchange and/or in an attempt to secure higher prices for its remaining volume).

Financial derivative markets will not develop if the market for the underlying physical product is illiquid. This is again demonstrated by the Wallumbilla experience, where there have been no trades of the Wallumbilla gas futures since these products were introduced by the ASX in April 2015.

Replacement of the DWGM gross pool with a voluntary exchange based market may also create barriers to entry in other ways.

- **Minimum size parcel of 1 TJ per day is too large for new entrant retailers** - The minimum parcel size of 1 TJ per day for on-screen products on the Gas Supply Hub (or for Balance of day products, 25 GJ/hour), is likely to be too large for small participants, particularly new entrant retailers who may be in their infant phase of development and attempting to grow organically. Lowering the minimum quantity may not be an appropriate way forward either, as it may result in sellers who are not interested in trading small quantities, specifying their sell orders as “All or None” (which would erode flexibility for all) or moving off market. In contrast, the current DWGM allows small participants to source gas to the precise GJ required through the pool, where price is determined transparently and where participants can be confident in a market price that is reasonably reflective of demand/supply conditions at the particular point in time.

⁸ Based on AEMO “Historical Transaction Summary” data from 21/03/14 to 16/11/16, on average there have been 2.1 trades per day (calculated across trades at all trading locations and across all product types).

⁹ ERM Power has observed that a similar bid/offer spread tends to appear on both the SWQP and RBP locations; i.e. even if the bids and offers were amalgamated at a single location, on most occasions the bid/offer spread would not be materially impacted and there would be no increase in the number of trades executed.

- **Higher costs** - Currently there are no fixed costs involved in operating in the DWGM. In contrast, to use the Trayport trading platform, a participant will need to pay \$14,500 per year per user licence and \$5,500 per year for each additional licence, noting that under the terms of use there can only be one active log on per licence at a time (meaning that if an organisation wishes to enable multiple traders to concurrently access the trading platform, it will need to purchase a licence for each trader). This increased cost may deter participation in the voluntary market and act as a barrier to entry.
- **Loss of transparency** - Removal of the gross pool will result in a significant amount of data transparency being lost. The current bid stack data provides valuable information including quantities of gas contracted at various supply sources, how participants value their gas and an insight into trading strategies. Loss of this public data will have a negative impact on smaller participants and potential new entrants whilst larger participants will have access to more market information (by virtue of their greater portfolio diversity and size). This will make it even more difficult for smaller players to compete and create an unnecessary barrier to entry for new participants.

Facilitating forward trading within the current market framework

We agree that in Victoria, short term trades are currently not common. However we believe that there are measures that can be implemented to promote forward trading without having to completely dismantle the existing arrangements. Increasing access to system injection and withdrawal points, and introducing mechanisms to enable administratively simple and low cost transfers of title at those points, are initiatives that would facilitate forward trading.

Each market participant could be set up to inject and withdraw at each system point as part of the registration process, and the allocation arrangements at each point could be made consistent (to the extent possible) and transparent. The charging structure associated with allocation arrangements at each system point should be reviewed to ensure that the charges are set at an efficient level.¹⁰

In particular, we believe that the establishment of trade points at all injection/withdrawal points in Victoria (and on major transmission pipelines), similar to the in-pipe and virtual trade points established on major Queensland pipelines and at Wallumbilla, would be instrumental in promoting forward trading by enabling transfers of title to gas between participants, without having to dismantle the DWGM. It would also enable swaps at different locations to occur.

The entry/exit rights model increases cost and complexity and reduces intraday flexibility

Under the AEMC's proposed model, managing the intraday position will be more costly and difficult - participants will need to have pre-purchased entry/exit capacity rights at all possible points of operation (and pay for such rights even if they don't use them), and align their capacity rights perfectly with their commodity purchases or sales. In comparison, under the existing market carriage model, capacity is allocated efficiently with commodity through the intraday gross pool scheduling process and participants are only charged for the capacity they use.

¹⁰ Currently to inject or withdraw gas at a point a participant needs to be accredited by AEMO to operate at that point, and also needs to have signed up to the relevant allocation arrangements. Allocation arrangements (and allocation agents) differ across system points in terms of methodology, costs and terms and conditions. Allocation arrangements are also not publicly available, as they are a form of contract and generally only made available to participants who are party to the contract or those who can demonstrate that they genuinely intend to operate at the particular point.

The entry/exit rights model makes it more costly and complex to move gas in and out of Victoria

The AEMC's proposed model will also make it harder for a participant operating on an interconnecting pipeline, to buy (or sell) gas from (or to) Victoria due to the same reasons as described above.

We also disagree with the AEMC's claim that the introduction of the Southern Hub model would bring Victoria in alignment with the Northern hub arrangements, and that this alignment would promote trading between locations.¹¹ In our view, the proposed Southern Hub will be significantly more complex, with completely different set of risks to manage, given that it will involve a balancing regime and a system of entry/exit capacity rights, and financial exposure from the hub operator management of transmission system constraints.

The proposed balancing regime is likely to be costly and impose unmanageable risks on small participants

Given the risk of low liquidity on the exchange and the fact that larger participants may prefer to retain any contracted flexibility in their supply arrangements to manage their own position (or sell their flexibility only at a premium into the market), balancing costs are likely to be higher than in the current market where balancing occurs transparently and competitively via the mandatory gross pool and bid/offer process. The proposed "continuous" balancing model is also likely to result in increased operational costs as participants will have to monitor the balancing position continuously throughout the day. This can be a particularly onerous requirement for large industrials or any small player who does not have a large 24/7 trading operation. The proposed balancing regime also creates unmanageable financial risks for small players who are less likely to have access to flexible gas supplies to manage their own balancing position or sell as balancing gas into the market.

Given that only a small number of participants are likely to have access to flexible gas supplies, there is also a risk that sellers of balancing gas are able to act in such a way so as to push up the overall costs of balancing, resulting in wealth transfers and market inefficiencies.¹²

The need for transitional measures to stimulate liquidity raises questions about the suitability of the model being proposed

In response to stakeholder concerns about the possible lack of liquidity, the AEMC has proposed a set of transitional measures designed to stimulate liquidity, including a daily balancing regime, financial tolerances (to cap participant's individual exposure to balancing costs with the residual costs being socialised) and a market maker role (requiring certain participants to submit bids and offers).

While we appreciate the AEMC's consideration of the issues raised by industry, the need for such intervention raises doubts about the suitability of the AEMC's proposed model in the context of Victoria. It is also unclear as how such transitional measures might help to address liquidity issues on a permanent basis – what happens when those measures are removed?

We also have some concerns with the proposal to socialise balancing costs as it would mean participants are exposed to the costs caused by others, and this could result in perverse incentives.

¹¹ AEMC, Draft Final Report, page v and discussion in section 3.2.4 (pg 38).

¹² The market for Frequency Control Ancillary Services (FCAS) regulating services in South Australia is an example of a market comprising a small number of sellers who have been able to bid in such a way so as to set consistently high prices and extreme prices under certain network conditions. In 2016, there have been numerous occasions where the cumulative price threshold for such services has been reached. While FCAS prices are based on a clearing price, rather than pay as bid as per the proposed Southern Hub model, the example highlights the risk that in a market with a small number of sellers, it is possible for sellers to influence the price through their bidding behaviour.

Small participants could be adversely impacted if the design exposes them to disproportionately high socialised costs caused by a larger participant.

The theoretical benefits from an entry/exit rights model should be assessed against the benefits that will be lost from removing the open-access market carriage regime

We agree that under the existing market carriage arrangements, where it is price that determines the right to flow gas¹³, the incentives for market driven pipeline investment are not strong. However there is no evidence that the current regulatory process for investment, where APA GasNet submits a proposal and the AER approves pipeline expansions, is resulting in inefficient outcomes or excessive costs to consumers. Any theoretical benefits from an entry/exit rights regime should be weighed against the benefits lost from discarding the existing market carriage regime. The existing open access market carriage regime is one of the reasons why barriers to entry are low in Victoria, and why Victoria is the market with the highest level of retail gas competition across the east coast of Australia.¹⁴

Recommended way forward

The DWGM, while not perfect, has proven to be an enabler of new market entry, retail competition, interregional trade and participation by a wide range of industry participant types (retailers, industrial users, gas fired generators, traders). If these arrangements are to be discarded, there should be a high level of certainty that the replacement model will result in significant net benefits for consumers and deliver the policy objectives being sought, and do so more effectively and efficiently compared to feasible alternatives. If not, the exercise will be a costly experiment that will ultimately be at the expense of Victorian gas consumers.

ERM Power recommends that prior to any decision on the way forward, the review needs to allow for the following (which could be undertaken under the direction of the Gas Market Reform Group) -

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

Please feel free to contact me if you would like to discuss our submission. We would also be pleased to meet with the AEMC for a discussion.

Regards

A handwritten signature in black ink, appearing to read 'SK', with a long horizontal flourish extending to the right.

Sarah Kok
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¹³ Other than in tie-breaking situations, where it is AMDQ or AMDQ Credits, utilised as an injection hedge nomination, that determines priority.

¹⁴ The AEMC 2016 Retail Competition Review found that competition in the retail gas market in Victoria is stronger than in other jurisdictions (section 4.5). The 2015 Retail Competition Review (Chapter 8) found that compared to other states, Victoria had the highest number of gas retailers and the lowest level of market concentration.