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Mr John Pierce
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Australian Energy Market Commission
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Dear Mr Pierce

REVIEW OF THE VICTORIAN DECLARED WHOLESALE GAS MARKET

As you are aware, there are significant structural changes being experienced in the eastern Australian gas market. The Victorian Government recognises that gas market arrangements in the Victorian Declared Wholesale Gas Market (DWG) need to be flexible so that end users, such as industrial and commercial customers, as well as retailers, have the ability to effectively manage risk in the DWGM.

The Victorian Government therefore requests that the Australian Energy Market Commission (AEMC) undertake, in consultation with the Australian Energy Market Operator (AEMO), a review of pipeline capacity, investment, planning and risk management mechanisms in the Victorian DWGM.

In November 2014, the Council of Australian Governments' Energy Council Ministers agreed to the Victorian Government tasking the AEMC to undertake the DWGM review.

I am pleased to provide the Terms of Reference for the review. The Terms of Reference state that the review will be undertaken over a maximum period of 18 months and is capped at cost of \$1 million (GST inclusive).

While this DWGM review will be undertaken separately to a concurrent review that the AEMC is conducting on Australia's facilitated gas markets, the Victorian Government recognises that there will inevitably be links between the recommendations and findings of the two reviews.

The Victorian Government is to fund the DWGM review and will make payments directly to the AEMC according to an agreed work plan. I invite the AEMC to prepare a draft work plan,

for review by the Victorian Government, so that this important work may commence without delay.

I look forward to seeing the results of the review.

Yours sincerely



Mark Feather
Executive Director
Energy Sector Development Branch

Date: 4 / 3 / 2015

WORKING DRAFT TERMS OF REFERENCE
REVIEW OF THE VICTORIAN DECLARED WHOLESALE GAS MARKET

Background

The Victorian Government recognises that improvements may be made to the operation and efficiency of the eastern Australian gas market, to better facilitate market transparency and transmission capability, and increasing gas supply to meet rising demand at competitive prices.

The Victorian Declared Wholesale Gas Market (DWGM) is a single integrated market that provides participants with the ability to trade imbalances and purchase wholesale gas. The market was established by the Victorian Government in March 1999 to support full retail contestability and encourage diversity of supply and upstream competition.

The DWGM is operated by the Australian Energy Market Operator (AEMO). Between 1999 and 2007, the gas price was determined on a daily ex-post basis. From 2007, the market moved to ex-ante intra-day trading following a review by VENCORP in 2003-04, which found that the existing design did not provide participants with the ability to respond to changing market conditions throughout the day.

The DWGM facilitates trading and balancing arrangements for gas market participants, including retailers, gas-fired generators, large industrial users and producers. Since the inception of the DWGM, the market design has stimulated a competitive retail gas market and safeguarded the security of gas supply for Victorian customers. Currently, there are eight gas retailers competing in the retail market and six gas-fired generators connected to the Victorian Declared Transmission System (DTS). Notwithstanding this, substantial developments are set to impact the market over the next few years.

In response to the establishment of a liquefied natural gas (LNG) export industry, the east coast gas market will experience a structural change to demand and supply. Large volumes of gas from Queensland and South Australia will supply the LNG export plants, with end users in these states likely to source increasing volumes of gas from Victoria, transported north via the DWGM and Interconnect Pipeline or Eastern Gas Pipeline. With exports set to begin from late-2014, the domestic market is already feeling the effects of greater competition for gas. These developments are expected to put upward pressure on gas prices and have resulted in a renewed focus on the efficiency of the gas supply chain.

Given the uncertainty around market outcomes for participants, gas market arrangements need to be flexible enough to support a range of potential scenarios out past 2020. It will be important for end users, such as industrial and commercial customers, as well as retailers, to have the ability to effectively manage risk in the DWGM. To minimise inefficient congestion on the DTS, investment to expand the DTS needs to occur in a timely and efficient manner. Interaction between the DWGM and adjacent gas markets should also be as seamless as possible, as this will reduce transaction costs and unnecessary volatility for market participants, minimising costs for end users of natural gas.

It is critical that a review of the Victorian DWGM be undertaken to examine whether the significant structural changes underway in the eastern gas market require reforms to enhance the liquidity, transparency and flexibility of the current arrangements.

In this context, the Victorian Government has requested that the the Australian Energy Market Commission undertake, in consultation with AEMO, a thorough review of pipeline capacity, investment, planning and risk management mechanisms in the Victorian DWGM. The objective of this undertaking is to ensure arrangements for access to the pipeline capacity promote competition, risk management by market participants and provide appropriate investment signals and incentives.

The AEMC will undertake the review in accordance with this Terms of Reference and provide a report with recommendations to the Victorian Government for consideration.

The Victorian Government notes that the COAG Energy Council has separately tasked the AEMC with reviewing the design, function and roles of facilitated gas markets and gas transportation arrangements on the east coast. The two reviews are related in scope and similar in timing and it is expected that the relevant findings and recommendations to be reflected in both reviews (where appropriate).

Purpose

The review is to consider whether the DWGM provides appropriate signals and incentives for investment in pipeline capacity, allows market participants to effectively manage price and volume risk, and facilitates the efficient trade of gas to and from adjacent markets. More broadly, the review is to consider whether and to what extent the DWGM continues to effectively promote competition in upstream and downstream markets, in the long term interest of consumers.

These Terms of Reference are intended to guide the AEMC's review of the Victorian DWGM.

Scope

The AEMC is required to undertake a review of the Victorian DWGM that considers:

- 1) Effective risk management in the DWGM:** the ability of market participants to manage price and volume risk in the DWGM and options to increase the effectiveness of risk management activities.

The Victorian Government is concerned that an inability for market participants to effectively hedge risk in the DWGM is limiting the potential of the market to achieve greater transparency and efficiency of trade in natural gas.

The ASX Victorian Wholesale Gas Futures Product is available but not widely traded as it can only be used to hedge against the ex-ante market price and not uplift charges. Further, while Authorised Maximum Daily Quantity (AMDQ) and AMDQ credit certificates provide participants with some protection against uplift charges, they cannot be used as a hedge against surprise or common uplift charges.

The AEMC is to investigate the underlying issues that are preventing greater use of derivatives and other risk management tools in the DWGM, outline the features of an efficient financial derivative market for gas and the changes that would need to be made in the DWGM to facilitate this.

- 2) Signals and incentives for efficient investment in and use of pipeline capacity:** whether market signals and incentives are providing for efficient use of, and efficient and timely investment in, pipeline capacity on the DTS.

Investment decisions to augment the DTS are currently largely made in response to a five year regulatory determination process. While the DWGM arrangements provide a form of tradeable pipeline capacity rights, through AMDQ and AMDQ credits, these rights have limitations in terms of providing certainty of access when the pipeline is constrained, and in allowing "free-rider" access when spare capacity is available. Consequently, they have been of limited effect in supporting private pipeline investment in the DTS. Investment guided by regulatory processes may be less efficient and timely than relying on market driven incentives. If firm, tradeable access rights to pipeline capacity were available, in a form that addressed these current limitations, this may enhance private investment, as prices for the access rights would signal the need for future investment.

The AEMC is to investigate whether investment in the DTS is expected to continue to occur in a timely and efficient manner. This investigation should also consider the interaction between regulated and private investment and whether the costs of pipeline investment and usage are allocated to users on an equitable basis. If appropriate, the AEMC is to recommend changes to strengthen the signals and incentives for efficient investment, and enhance access to, and short term trading of, pipeline capacity.

3) Trading between the DWGM and interconnected pipelines

To maximise the efficiency of trade in natural gas and facilitate competition in upstream and downstream markets, producers and shippers should be able to effectively operate across the different gas trading hubs on the east coast without incurring substantial transaction costs.

The AEMC is to examine if, and to what extent, the current DWGM arrangements inhibit trading of gas between the DTS and interconnected facilities and pipelines. Elements like transparent, adaptable pricing between the DWGM and interconnected pipelines, combined with ready access to pipeline capacity, may be required to enable shippers to better manage risk and facilitate the efficient trade of gas between interconnected hubs and pipelines.

In considering items 1 and 2 above, the AEMC should examine alternative pricing, risk management and pipeline access mechanisms for the DWGM that would also enhance efficient trading of gas with interconnected pipelines and facilities.

4) Promoting competition in upstream and downstream markets: whether the DWGM arrangements continue to facilitate market entry and promote competition in upstream and downstream markets and how this could be improved.

Taking into account the analysis and any recommendations from the areas of review above, the AEMC should assess whether the DWGM continues to effectively encourage the introduction of new gas supplies to the market and promote competition among retailers in the sale of gas. The AEMC should also comment on the extent to which the design of the DWGM may be a deterrent to large users of gas from participating in the market where it may otherwise be commercially practical for them to do so, and the extent to which this may have an adverse impact on gas usage, trading and market liquidity.

If the AEMC proposes recommendations for market reform, it should clearly demonstrate to the Victorian Government and Council of Australian Government's (COAG) Energy Council how the recommendations address the issues identified, that they continue to safeguard the security of gas supplies to Victorian customers, are proportionate to the problem being addressed and how they promote the national gas objective.

Considerations

In undertaking the review and forming its recommendations, the AEMC is to consider:

- the physical characteristics, size, maturity and interconnectedness of the Victorian gas market;
- the nature of the commercial arrangements underpinning the supply and transportation of gas;
- developments in other eastern Australian gas markets; and
- relevant international experience.

The AEMC is also to consider and incorporate (where appropriate) the findings and recommendations from its concurrent review of Australia's facilitated gas markets.

More broadly, the AEMC is also to consider:

- the national gas objective; and
- the COAG's Gas Market Development Plan.

Consultation

The Victorian Government requires that the AEMC undertake a formal stakeholder consultation process, including the release of an issues paper, options paper and a draft report for consultation at minimum. If considered appropriate, the AEMC should also hold public forums and/or workshops.

The AEMC is required to establish a stakeholder reference group that will meet periodically throughout the review and prior to the completion of each of the review milestones, and comprise membership of AEMO, representatives of pipelines, consumers, retailers, producers, large users and any other party the AEMC deems appropriate. This stakeholder reference group will also be used for the AEMC's review of facilitated gas markets on the east coast and additional Victorian-specific representatives may be invited.

The AEMC is to utilise the experience of the Australian Energy Regulator as appropriate.

Timeframes and deliverables

The AEMC is to undertake the review over a maximum period of 18 months, taking into consideration the indicative timeframes set out below. This will allow the AEMC to undertake extensive engagement with stakeholders and propose well developed recommendations to the Victorian Government.

The Victorian Government notes that these timeframes represent an upper bound and the AEMC should use its best endeavours to complete each stage of the review promptly and ahead of schedule. Public consultation should be for a minimum of four weeks for each report and a copy of the draft and final reports must be provided to Victorian Government officials and the COAG Energy Council officials one week before publication.

Milestone	Timing
Public forum (in conjunction with the Review of Facilitated Markets)	February 2015

Publish Issues Paper	April 2015
Publish Options Paper	August 2015
Publish Draft Report, including request for Victorian Government response on any significant initiatives identified by the AEMC	December 2015
Publish Final Report	The final report will be published following receipt of the Victorian Government's response to findings and recommendations in the draft report

Before finalising a detailed implementation plan for its proposals in the final report, the AEMC will seek a formal response from the Victorian Government and the COAG Energy Council to some of its recommendations in the draft report.¹

¹ For example, if the AEMC proposes significant changes to the National Gas Rules, the AEMC will seek a response from the COAG Energy Council at the draft report stage before finalising the review.