



# ***Major Energy Users Inc.***

31 March 2016

The Commissioners  
Australian Energy Market Commission  
PO Box A2449  
Sydney South NSW 1235

Sent by: online lodgement

Dear Sirs

## **Discussion Paper Review of the Victorian DWGM GPR0002**

Major Energy Users Inc (MEU) is pleased to provide its thoughts on the second Discussion Paper regarding the Victorian Declared Wholesale Gas Market (DWGM) review. The MEU provides the following comments which are intended to augment the views provided in the responses to the first discussion paper and the draft report on the DWGM.

The MEU notes that the second discussion paper attempts to address some of the aspects in the draft report which were not more fully developed and where respondents to the draft report had commented there was insufficient detail to provide more detailed feedback. In providing the greater detail, what the discussion paper does is to raise more concerns, and some of these are addressed below.

At a high level though, the MEU is concerned that the AEMC has elected to continue with developing the new approach for the DWGM, especially with such strong resistance to and concerns raised by well informed participants and consumers. In the second discussion paper, the AEMC advises that it has reviewed submissions made to its first discussion paper and draft report and, along with its own analysis, has determined that the east coast gas market and Victorian consumers will be better off by undertaking a major change to the current market structure.

Based on its own review of the submissions made during the DWGM review process, it is apparent to the MEU that the AEMC has decided the most informed respondents<sup>1</sup> are wrong in their considered views that the DWGM does not need to undergo the proposed major change to an entry /exit model (package D) and that many consider that market improvements (package A) only are needed. Further, there is a view that the proposed changes could well result in considerably more costs to the market and Participants (and hence to all consumers) than is warranted, especially noting that the

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<sup>1</sup> That is, those respondents who have actually worked and operated in the DWGM as producers, pipeline owners, shippers and direct connected consumers.

current arrangements have served Victorian gas users well and that the physical attributes of the DTS militate against the proposed concept.

Despite these views of caution, the AEMC has determined that its proposed reforms are better for the east coast gas market and, it would seem, Victorian gas consumers. MEU members have been operating in the DWGM since the market was first developed and implemented in the late 1990s and consider that it continues to serve Victorian consumers well, although the MEU accepts that incremental improvements could and should be made as has occurred since the DWGM since its implementation.

In its second discussion paper, the AEMC comments (page i) that:

"Based on submissions, and having undertaken its own analysis, the Commission has presented a package of reforms to the COAG Energy Council which aims to deliver the Energy Council's Vision and achieve the best outcomes for Victorian consumers, consistent with the National Gas Objective (NGO)."

The MEU finds it amazing that the AEMC can make such a statement that it has based its package of reforms on submissions and concludes that its proposal for the DWGM will provide a better outcome for consumers than the existing arrangements. The MEU remembers well the consultative approach used by the Gas Reform Taskforce (developing the third party gas access regime), the Victorian Government (developing the DWGM) and the Gas Market Leaders Group<sup>2</sup> (developing the STTMs), where in-depth consultation (whether at the decision making level or at the detail examination and development level) was at the very core of the evaluation and development process. This contrasts to that used by AEMC where detailed decision making is carried out in isolation and consultation has been essentially at arms length.

The MEU is very concerned that the AEMC has embarked on a review of the DWGM but has failed to incorporate the very real experience held within AEMO about the detailed operation of the DWGM and its development. AEMO comments<sup>3</sup>:

"AEMO appreciates the opportunities provided so far to feed into the design process through formal submissions to the initial working paper and to this draft report. However, given that the review must now turn to matters of detail, AEMO considers that a more active and frequent consultation process would be useful. As the AEMC develops a high level or detailed design, there are likely to be substantive matters that will need to be tested and validated with industry. AEMO encourages a process that enables greater industry involvement. Some form of technical working group process (similar to what was done in the information stream) may aid industry engagement."

Implicit in this comment is an observation that the AEMC has used little of AEMO's undoubted knowledge about the reasons for why the DWGM is as it is or to gain an understanding about the unique features of the DTS. The MEU considers this is a significant oversight by the AEMC and it has not allowed the AEMC to better understand the unique features of the DWGM and DTS.

The MEU also notes that the AER response to the east coast gas review includes significant commentary on the proposed changes to the DWGM. The AER comments

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<sup>2</sup> In concert with AEMO

<sup>3</sup> AEMO submission to draft report 12 February 2016 page 8

on the DWGM also imply that there needs to be a strong case for change, especially when it is recognised that the current arrangements already provide most of the features that the AEMC state as being required.

Specifically, the AER comments that greater investigation is required to understand why the derivatives market has not developed to the extent desired but the AER also points out that the Wallumbilla Hub also exhibits low trading activity in derivatives even though its design was specifically to enable greater trade in derivatives. As the MEU pointed out in its response to the draft reports, the low competition in gas supply probably is a major cause of low trading in derivatives, regardless of the design of the market.

An overarching concern from respondents to the draft report is that there has to be a significant benefit to transition from the existing arrangements to another mechanism due to the extensive costs that such a change will impose. Overall, respondents seem to consider that the bulk of the benefits coming from the proposed change can be achieved through incremental improvement to the existing DWGM.

In this regard the MEU notes that the AEMC second discussion paper still does not quantify any benefits but alludes to costs to implement the change. It also indicates that the proposed changes "should" and "may" deliver specific benefits implying there is a hesitancy in being determinative about the benefits contemplated by the change. For example, the AEMC comments:

- "However, while the intention is for all investment to be triggered by entry and exit capacity being booked by participants (that is, a market signal), the entire associated cost **may** not necessarily be met by participants and so some risk might continue to be borne by consumers." (page 7) (emphasis added)
- "This **should** lower transaction costs and complexity for large users and retailers operating across multiple markets, and thereby encourage greater participation." (page 9) (emphasis added)
- "In this context, the appropriate split between APA as the pipeline owner and AEMO as the current system operator **should** promote the efficient use and operation of the gas pipeline system." (page 16) (emphasis added)
- "Such a mechanism **should** trigger and allocate additions to, and expansions of, capacity that enable supply to meet demand while minimising the cost of excess capacity." (page 30) (emphasis added)

What is concerning is that the AEMC does not look at the benefits that could come from incremental change (option A) to identify whether the major change (option D) delivers benefits significantly greater than option A to offset the costs involved.

However, respondents to the draft report are more explicit than AEMO and AER in their concerns about the AEMC proposal. For example, the following quotes are from a range of respondents (covering pipeline owner, producers, shippers, retailers, and consumers) to the AEMC draft report on the DWGM, all of whom are experienced in the actual operations of and challenges faced by the DWGM:

- "**APA** is cautiously open to further exploration of the entry-exit model, but are as yet unconvinced that an entry-exit system would offer superior outcomes for Victoria as compared to incremental evolution of the existing DWGM."<sup>4</sup>
- "**AGL** is more cautious with regards to replacing the existing open access capacity model in the DWGM, with an entry and exit capacity rights model. AGL does not consider that it has been clearly demonstrated in the Draft Report that there is a definitive problem with pipeline investment in the DWGM to actually warrant the change."<sup>5</sup>
- "[**ERM** does] 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."<sup>6</sup>
- "In Europe, despite legislation and regulation requiring a somewhat similar framework to that recommended in Victoria, liquidity has only been established in limited locations. Whilst [**Esso**] supports ongoing, phased implementation of reforms to enhance the market, we are concerned about the high costs that will inevitably be incurred to develop and implement such major changes. These costs will ultimately be borne by the market. It is essential that each recommendation to implement a reform is supported by a robust cost benefit analysis. It is also essential, as the details of any reform are developed, that contract sanctity is respected."<sup>7</sup>
- "With regard to the proposed entry/exit model, while [**Origin Energy**] agree that this could assist in enhancing investment signals, a crucial starting point is the current state of investment in the DWGM. Notwithstanding the market carriage framework, participants have the ability to fund pipeline augmentations, and it has yet to be determined that the current arrangements have resulted in a suboptimal level of investment. ... While any cost benefit analysis is likely to prove complex, an important consideration in assessing the merits of the recommendations for the southern hub, is the extent to which the expected benefits can be achieved through targeted improvements to the current market arrangements. The key decision making parameter would then be which approach (i.e. incremental changes or more radical re-design) can achieve the desired outcomes at least cost."<sup>8</sup>
- "**GDFSAE** notes that the entry-exit model does provide a potential mechanism to improve network capacity procurement and risk allocation, but is also mindful of potential complexity and has a level of concern at the suitability for the Victorian context."<sup>9</sup>

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<sup>4</sup> APA Submission to AEMC draft report Review of DWGM, page 3

<sup>5</sup> AGL letter to AEMC dated 12 February 2016 page 2

<sup>6</sup> ERM letter to AEMC dated 12 February 2016 page 2

<sup>7</sup> Esso letter to AEMC dated 12 February 2016 pages 1 and 2

<sup>8</sup> Origin Energy letter to AEMC dated 17 February 2016 page 3

<sup>9</sup> GDF Suez letter to AEMC 17 February 2016 page 3

- "The [Australian Energy Council] supports the AEMC's focus on facilitating the development of liquid wholesale gas markets. However, particularly with respect to the changes proposed to the DWGM, members are cautious about whether the identified benefits will exceed the implementation costs and are concerned about the transition, including the proposed treatment of long-term legacy contracts and existing contractual rights."<sup>10</sup>
- "[Energy Australia considers it is] therefore important that changes are assessed and costed at a relatively detailed level to ensure that a reform package is worthwhile."<sup>11</sup>

These tend support the views expressed in the MEU response to the draft report that the AEMC proposal for change is probably not needed to overcome the few identified shortcomings of the DWGM, especially considering the physical constraints in the DTS that the DWGM has to accommodate. That the AEMC persists in developing further refinements through the release of its second discussion paper belies the fact that there is not widespread support for the change from those market participants which really understand the physical attributes and shortcomings of the DTS and the extent to which previous examinations of options have already assessed and discarded various elements of the AEMC proposal.

The AEMC states that the review of the DWGM requested by the Victorian government was to consider whether the existing gas market arrangements in Victoria:

- allow participants to effectively manage price and volume risk;
- provide appropriate signals and incentives for investment in and use of pipeline capacity; and
- facilitate the efficient trade of gas to and from adjacent markets.

Rather than address whether the existing market provides adequately for these features or whether the existing structure could be improved to address shortcomings, the AEMC has embarked on a wholesale re-design of the DWGM. What is not clearly substantiated is whether the AEMC proposal actually achieves these outcomes<sup>12</sup> or whether the benefits are outweighed by the costs to make the changes - costs not only for the market operator, but all of the participants and consumers that will have to operate with the new approach. Clearly, from the comments above, there is widespread concern about the cost impacts of the approach proposed by the AEMC.

### Capacity allocation

For example, the AEMC has posited that one of the driving forces for change is that there might not been sufficient investment in pipeline capacity and that its proposed entry/exit model overcomes this by providing market signals at the entry and exit points. What the draft report (and the second discussion paper) does not do is identify how there will be sufficient investment within the hub for users within the hub<sup>13</sup> or how this will be signalled. The MEU notes that under the proposed change to the DTS there are 4 production entry points, 4

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<sup>10</sup> Australian Energy Council letter dated 15 February 2016 page 3

<sup>11</sup> Energy Australia letter to AEMC dated 12 February 2016 page 1

<sup>12</sup> Commentary from responders highlight shortcomings of the AEMC proposal

<sup>13</sup> That is, those users that are not involved with export of gas from the hub

interconnection entry/exit points, 2 storage entry/exit points, and 12 direct connected exit points for large end users - all of these would be subject to an auction process for allocating capacity. Additionally there are 111 exit points that connect to the distribution networks, and these would have automatic allocation of capacity with the capacity allocated to retailers representing smaller gas end users.

In contrast to a point to point pipeline system which can readily auction capacity at entry and exit points, the DTS is, to all intents and purposes, more characterised as a distribution network and has little line pack capacity. The MEU therefore considers that the AEMC attempts to develop a workable system for capacity allocation and investment for the DTS should reflect more applicability to a distribution network that the DTS resembles. Yet it is clear that the approach proposed would not work for a distribution network due to the complexity involved.

For example, for a shipper seeking to inject gas at the Port Campbell facility with a view to take delivery (ie exit) at the Culcairn exit point, there is an assumption that the network internal to the hub will be sufficient to provide the transit of the gas. Yet the bulk of the gas transiting the DTS is consumed within the network and, as there are some 111 exit points within the hub connected to the distribution networks, the actual capacity and usage within the hub will impact considerably on the ability to allow gas to transit the hub. This means that the auction prices for the injection point and exit capacity could vary considerably within a day due to potential congestion within the hub and this reduces considerably the certainty of price for transiting the gas across the hub<sup>14</sup>. There is an implicit assumption that short term congestion will not impact the ability to inject/extract gas, presumably through increases/decreases in line pack. The physical attribute of the DTS is that there is little line pack to provide this service and what is not clear is why the entry/exit model can provide this line pack when the DWGM had to move to intraday balancing to manage the congestion. An auction process for capacity implies a right for the successful bidder to inject/extract gas at a point in the network yet there is no control of gas extraction at the 111 distribution points and it is this that controls congestion at all of the points where auctions have already occurred.

Again, for the 12 direct connect customers, the AEMC points out that they will have little competition for capacity at the exit points and so the exit price would vary little. Yet what happens when there is a new entrant user at the exit? There will be an auction and for the time between when the new entrant seeks access and when any augmentation is completed, there will be a shortage of capacity for one or the other user. What occurs now is that the new entrant identifies its needs ahead of when gas is used and any augmentation is implemented. But an auction process will only occur when the need is imminent.

The MEU queries how is the auction process carried out if a new entrant within the hub seeks capacity, and there is competition for capacity between the new entrant at its internal exit point with (say) the shipper seeking to transit gas between Port Campbell and Culcairn where the new entrant requirements reduce the ability to extract gas at Culcairn. The MEU sees that there is

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<sup>14</sup> The MEU notes that auctions for capacity would be quarterly



potential conflict between auctioning the same capacity at two different exit points with potentially two different needs.

Such an issue also raises the question as to why a long time user of the DTS should be "out bid" for capacity by a new entrant seeking to export gas from Victoria. While the export might be in the interests of consumers outside of Victoria, it disadvantages the long time user who has effectively provided the funds for the development of the DTS and the ability of the exporter to use assets underwritten by the long term user.

The second discussion paper comments that any augmentation required would be through direct negotiation with APA. The MEU points out that a negotiation of this sort is not balanced as APA has market power and can set the costs for augmentation at whatever it considers it wants. In its submissions to the ACCC and the AEMC, the MEU points out that direct experience of large users having to negotiate with a monopoly pipeline owner is fraught as "Negotiating with a Monopoly" is an oxymoron. MEU members have provided first hand experiences to the ACCC about their experiences in negotiating with pipeline monopolies. Further, if the additional capacity is required to be provided at a distance away from the connection point, the ability to "negotiate" becomes even more difficult because of information asymmetry.

The second discussion paper cites that APA would be responsible for auctioning capacity and, from the results of the auction process, APA would determine the need for augmentations and would seek AER approval for the expenditure. This raises the question as to whether APA is sufficiently disinterested in the auction process to ensure that the most efficient outcome will be achieved.

## **AMDQ**

The MEU is very concerned that the AMDQ concept is to be eliminated under the AEMC proposal. The AMDQ concept was established to ensure that end users have sufficient capacity for their needs and that this capacity right could not be removed from them. There are two over-riding concerns for consumers regarding allocation of capacity and the reasons for developing the AMDQ concept.

1. End users have made significant investment in their own facilities that is underwritten by an assumption that they will continue to have access to gas to support their long term operations. This capacity was developed and effectively paid for by the initial end user before the development of the DWGM. The loss of this "right" of the capacity to another user could effectively make the investment by the end user valueless through the loss of this capacity to access gas. To protect its investment, the initial end user was allocated the AMDQ capacity right to ensure that what it had underwritten in the past would remain available to it over the life of its own investment. The removal of the AMDQ right and to auction this capacity could well make the initial end user unable to provide its services to customers in another market. This downstream effect is entirely overlooked in the attempts to make the gas market supposedly more efficient.

2. That the AMDQ is allocated to the end user allows the end user to change between retailers with ease. In markets where the capacity is "owned" by a retailer through a shipping contract with a pipeline owner, this provides a de facto ability of a retailer to prevent competition. Auctioning of capacity could allow a retailer to acquire all of the capacity and prevent end users an easy ability to select its own retailer based on competitive pressures.

### **Contract carriage vs Market carriage**

The MEU notes that the AEMC approach is to remove the DWGM basis of it being operated under a market carriage model as applies in gas distribution networks and, indeed the electricity market. The AEMC has not explained why it considers the contract carriage model provides a better outcome for consumers than the market carriage model used in the DWGM. If market carriage works for distribution (to which the DTS is very similar) and the electricity market<sup>15</sup> why is there a determination to change from a market carriage model for the DTS? The assumption is that a contract carriage model provides a clearer signal for new investment, yet why does this not apply equally in other markets where market carriage works well?

### **Market liquidity**

Another driving force behind the proposed change is that there is a supposed need for more liquidity in the DWGM and that liquidity this is being limited by the potential for unforecasted uplift payments when there is congestion.

What is not compared to this unforecasted payment is the unforecasted payment for balancing charges when a party is not in balance. The MEU notes that in the balancing section of the discussion paper, there is an assumption that line pack will provide an ability to minimise out-of-balance costs. Yet the DTS has limited line pack (even with the Dandenong LNG plant) and this caused the need for intra-day balancing which subsequently resolved much of the uplift payment.

### **Allowed revenue**

It is not clear whether the new auction process to be controlled by APA will provide APA with a windfall. Effectively the reference prices set for the entry and exits will be based on the revenue allowed by the AER but with congestion, there will be an auction which will result in higher prices for the capacity at the entry/exit.

The MEU has seen that over time, a price cap arrangement delivers more revenue than is forecast by the application of the reference price to the capacity provided. This is one of the reasons given by the AER to move from price cap regulation to revenue cap regulation in the electricity distribution sector.

As APA is to carry out the auction process for capacity, there is an incentive for APA to recover more from each access point than the reference price if the rewards of the auction are to be retained by APA. As proposed, the allowed

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<sup>15</sup> And many other infrastructure services like roads and water supplies



revenue would be used to develop reference prices but if there is an auction which delivers more than the reference price<sup>16</sup>, then there will be greater recovery of revenue than expected.

It is not clear whether this additional revenue will be retained by APA or used to offset prices in the following year; as would occur under a revenue cap. However, under the pipeline capacity auction process, it appears that the AEMC supports that the extra revenue from an auction process would go to the pipeline owner. If this is the case, the MEU considers that such an approach would not be appropriate for the DTS as revenue is already guaranteed through the regulatory process

### **Balancing at the Southern Hub**

The current arrangements for balancing the DWGM work well. Where there is congestion and this is caused by out of balance nominations, a charge is levied because over or under nominations as out of nomination in a pipeline system with low line pack can cause significant harm to other shippers. These charges are assigned to those that caused the problem<sup>17</sup>.

It would appear that the process proposed by AEMC is that by aggregation of all over and under nominations the out of balance can be smoothed out, with one shipper's over nomination being cancelled by another's under nomination. Such an approach has two key repercussions

1. There is less incentive to be accurate in nominations.
2. There is still a cost incurred as a result of the net imbalance residual penalty which is unknown in the market. Further, this cost should be assigned to those that caused the problem but as under the AEMC proposal the only outcome that will be known is the net cost. This then creates the problem as to how best to assign the cost. In this regard, because the DTS has such limited line pack, both over and under nominations can lead to significant costs to keep the system balanced. The MEU is concerned that as the out of balance cost would now be a net amount, identifying causers will be more problematic and there will be a reversion to the allocation of balancing costs being "smeared" across all shippers rather than assigning costs to causers.

The AEMC asserts that exchange based trading coupled to an entry/exit model as used in Europe more closely reflects the DTS and therefore the success of that model in Europe can be replicated in the DTS. The MEU disagrees as the DTS has so little line pack compared to that in the European example.

The MEU is aware that in the development of the DWGM, the European model was examined but due to the complexity of the DTS (as it more closely reflects a distribution network) and the lack of line pack, it was determined that the

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<sup>16</sup> As is expected in order to signal new investment

<sup>17</sup> It also needs to be remembered that under the current arrangements, there is no resultant benefit to AEMO in the levying of charges and any excess revenue is shared with other shippers.

entry/exit model would be unlikely to be successful. That the unique DWGM approach has proved to be so successful supports this view.

### **A realistic market price for gas**

A third driving force is that it is asserted the current arrangements do not provide a realistic price for gas in the DWGM. The MEU points out that nowhere in the AEMC reports is there a clear explanation that the revealed spot prices in the DWGM are not "real".

The MEU is aware of end users that source their gas (or part of their gas) requirements from the spot markets (DWGM and STTMs) at the market prices. In this way, the spot market does provide a real price for gas as users pay this price for gas. The MEU notes that the AER has a similar view noting that participants are already buying and selling gas in the STTMs and the MEU is aware that the same occurs in the DWGM.

### **Is change in the DWGM needed to trade into other regions?**

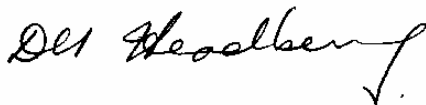
Finally, the MEU asks why the current arrangements for the DWGM do not support the overall east coast gas market concept sought by the CoAG Energy Council. There is no doubt that gas can flow from the DWGM into the wider east coast gas market at prices determined from the DWGM spot market as this already occurs, although the MEU recognises there are some difficulties. These difficulties could perhaps be resolved through an incremental change without the need for major change.

The MEU notes a concern raised by AEMO that converting to an entry/exit model might not readily accommodate cross border trade to the contract carriage that applies in all pipelines leaving Victoria.

The MEU is very concerned about the approach used by the AEMC to develop its final report to CoAG Energy Council, especially considering the limited involvement of those with specialist knowledge of the DTS and the DWGM.

The MEU is very interested in further discussing its views with the AEMC and is open to providing more explanation if needed.

Yours faithfully



David Headberry  
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