

17 November 2004

Manager – Energy Market Reform Branch
National Energy Market Branch
Department of Industry, Tourism and Resources
GPO Box 9839
Canberra ACT 2601

Dear Sir or Madam

National Gas Emergency Response

I write to you in response to the National Gas Emergency Response [Protocol] Issues Paper and also to express APPEA's grave concerns more broadly about the totally unreasonably short amount of time being given industry to respond to complex issues throughout the gas market reform process.

The gas market reform process appears to be driven by inappropriate and unnecessary timeframes and therefore runs the risk of delivering unsuitable outcomes. A number of papers have been presented to industry for consideration apparently favouring a particular outcome, even though in the view of APPEA much of the prerequisite work is yet to be reviewed and understood by all stakeholders. For example, to the best of APPEA's knowledge, a thorough review of the response to recent emergencies, in particular the outages at both Longford and Moomba, have not been sufficiently examined and understood by government and industry to ascertain key learnings. At the very least, any learnings from these events should be directly discussed with industry. A number of questions remain unanswered, for example:

- could the response by industry and government have been better, and if so, how?
- what information was missing that could have better informed the response?
- to what degree could the market have responded before government intervention was required? What changes should be considered?

It is APPEA's view that these questions need to be thoroughly addressed with the relevant parties involved before formulating any kind of formal emergency response process. A meeting between appropriate industry and government representatives should be able to answer these questions and identify any outstanding issues. Indeed, APPEA suggests that there is a need to step back and take stock of the issues without rushing towards meeting an unreasonable and unnecessary deadline.

APPEA is also extremely concerned that the current nature of the gas market has not been effectively taken into consideration when drafting the issues papers (see Attachment A). In both the emergency response protocol issues paper and the paper on principles for gas market development, there appears to be an underlying assumption that the forced development of a wholesale market will deliver an effective market response to any catastrophic failure in gas supply. Based on observations from such major outages, any such regulated market would simply have to be suspended as unworkable during such events. In APPEA's view, an emergency occurs where there is clear market failure. There are a very limited number of events where this may occur, such as the incidents at Moomba and Longford (for example, an outage in a distribution network would not constitute a major sustained failure of the gas market). The effects of each of these outages would be different and on each occasion the operational response of the market participants would need to be somewhat different.

The implementation of a pre-determined, regulated wholesale spot market in South East Australia (given the current lack of depth and liquidity) would not provide the appropriate price signals to encourage a demand side response more effectively than is evident under current market practices. A wholesale spot market will come into existence when the market is able to sustain it. That is, when there is both a variety and a large number of buyers and sellers in the market. Indeed, a regulated wholesale market may be counter productive in that it is unlikely to encourage suppliers to put all available gas into the system. Communication between market participants is crucial to addressing market shortfall and the role of retailers to coordinate both supply and demand side responses cannot be understated. Effective and efficient consultation between market participants and government during the time of an emergency is perhaps the single most important principle.

When responding to a catastrophic failure of the gas supply system, APPEA believes there are four fundamental issues that need to be resolved:

1. Contractual Arrangements

First and foremost, the sanctity of contracts must be a foundation principle. Governments and industry must work together to ensure that the appropriate contractual provisions are put in place to manage supply shortfall. In the event of government intervention, compensation arrangements must be in place.

2. The point where clear market failure has occurred and where government intervention is required

Government intervention is clearly a matter of last resort. The point of intervention should be determined through consultation with industry and based on sound data at the time of the emergency. As far as practicable, the market should be left to balance the system and meet the needs of customers. It is the responsibility of those customers who require uninterruptible supply to include provisions to secure that quality of supply in their contracts. It is the

responsibility of government to determine and publish the list of preferential customers that have to be supplied in the event of an emergency intervention and establish the mechanism for just compensation if governments over-ride contractual arrangements.

3. Information requirements

APPEA understands the need of government to receive timely and accurate data throughout the gas chain at the time of an emergency. With that in mind, it must be noted that 365 day reporting would impose a costly burden upon industry that would deliver limited benefits to governments given that information rapidly goes out of date. A more appropriate model would be the formation of a National Gas Industry Emergency Committee (NGIEC), in a similar form to the National Oil Supplies Emergency Committee (NOSEC), to convene at the appropriate time to determine government and industry actions.

4. The agreement by governments to act in the best interests of the market as a whole

Given the growing linkages between states in the gas market, most notably between New South Wales, Victoria and South Australia, it is essential for state governments to act in the interest of all market without putting the needs of any one state as paramount to the needs of another.

With the above taken into consideration, APPEA would suggest an alternative path forward. The upstream gas industry proposes a meeting between representatives of operating companies and State/Territory and Commonwealth officials with the agenda of understanding how the market operates in practice and also the needs of government. As mentioned above, lessons from recent incidents should be taken into consideration.

The need for a prescriptive emergency response arrangement is also questionable given the dynamic nature of the gas market. Rather, the creation of a NGIEC should be formed consisting of four sub-groups (WA, NT, Qld, and the South East Grid), each focusing on:

- explaining corporate processes;
- identifying state processes;
- listing key contacts in companies and government;
- examining data requirements; and
- regularly conducting simulation exercises to test the effectiveness of the data gathering and communication system.

Such a group need not be overly large, or bureaucratically complex. Its membership should consist of:

- operators of the key upstream processing facilities;
- key pipeline operators;
- retailers; and
- a representative from each State/Territory and the Commonwealth.

4.

Should you wish to discuss in further detail any of the issues raised in this letter, do not hesitate in contacting me on 02 6267 0910 or via email at pgniel@appea.com.au

Yours sincerely

Peter Gniel
Director, Energy Policy

Attachment A: The Australian Gas Market

In Australia, gas can be best characterised as competing in three regional domestic energy markets:

- the Western Australia market;
- the Northern Territory market; and
- the integrated Queensland, New South Wales, Victoria, Tasmania and South Australia market.

Development of natural gas resources has historically been State based along with transmission infrastructure which was not interconnected on the east coast. As such, historically customers have had a high level of dependence on a single supply source.

Transmission and retail/distribution networks were highly protected by way of being serviced by government retail companies or private, regulated franchises. Governments also regulated retail gas prices.

The rapid uptake and growth in gas demand was supported by these low, regulated retail prices, with upstream development and downstream market development and growth underwritten by long-term gas supply contracts. The low producer prices and supply franchises led to a gradual stagnation of the eastern gas market. This situation is rapidly changing in all of the regional markets primarily as a result of the reforms of the 1990s, although this has not solved all the problems associated with getting more gas to markets.

Gas has been able to make gains in its market share of primary and final energy in large part due to significant construction of pipelines. According to the Australian Gas Association, there was an 113.9 per cent increase in the length of transmission pipelines in use between 1989 and 2002 – in 1989, the length of gas transmission pipelines in use was 9,399 km, and by 2002 this had increased by 10,710 km to 20,109 km. This has resulted in the interstate trade of gas and changes to transmission, distribution and retail companies.

The number of retailers hasn't effectively increased, but they differ in that they operate across states. For example, AGL formerly operated only in New South Wales, Gascor in Victoria, SAGASCO in South Australia, and Energex in Queensland. AGL now operates in New South Wales and Victoria, Origin operates in South Australia and Victoria, TXU operates in Victoria and South Australia, and Energex operates in Queensland, Victoria and New South Wales. Retailers have also adopted differing business strategies, such as:

- companies becoming energy retailers, selling both gas and electricity (AGL, TXU, Origin);
- vertically integrating with gas production (Origin with Yolla and Coal Seam Gas);
- diversification of a company's gas supply portfolio (AGL/TXU); and
- acquisition of significant gas-fired power generating assets (Origin in South Australia, TXU in Victoria/South Australia and Alinta in Western Australia).

Effectively, the gas market in the eastern states is becoming a single pool. That is, retailers have a portfolio of gas supply that can be moved around into any market. Once the Tasmanian market is fully developed, there will still be limited large growth opportunities for gas in the southern states in the near term, with no new industrial projects on the horizon. The role gas will play as a fuel source for new electricity generation, particularly in New South Wales and Victoria is unclear due to inter-fuel economics, although consideration of potential public benefits and addressing the unfavourable tax treatment for offshore gas would change this position. There are some potential growth opportunities in Queensland in both minerals processing and electricity generation, and in Western Australia, the largest gas consuming state, the growth outlook is positive driven by the resource sector and power generation.

Even after the significant advances arising out of the 1990s reforms, the Australian gas market is still relatively small, lacking liquidity and depth. A recent ABARE study has confirmed that this situation is likely to remain for some time. Ultimately it is more supplies and more customers connected by more pipelines that will provide depth to the market and , will encourage more trade in gas that will add further liquidity.

For production of natural gas in eastern Australia to keep pace with growing demand in the decade 2010 to 2020, the right development framework and market signals (including potential public benefits) will be needed to ensure sufficient gas reserves can be commercialised.

Key drivers for the demand for gas are:

- population growth;
- economic growth;
- inter-fuel economics; and
- consumer attitudes.

From an upstream perspective, developing Australia's gas resources faces a number of hurdles:

- because gas supply to a customer requires dedicated pipeline or LNG shipping infrastructure, new gas can only be developed once a commercial contract is signed with a customer, thereby underpinning the substantial development costs;
- the national and export markets Australia is seeking to supply are currently illiquid. Within the next 20 years the liquidity of the national gas market is not expected to change much;
- Australia's gas resources are located largely (but not exclusively) offshore and in high cost areas. In order to service potential export markets, the Australian industry is now moving further offshore and in deep water. By moving further offshore, the industry is faced with higher costs of development. Where 'dry' gas is concerned, there is no liquids-generated cash flow stream to augment the viability of any gas development;
- over 60 per cent of Australia's sources of residential gas demand are located in the south east and at a considerable distance from much of the

undeveloped known resources in the north and north west (on the other hand, much of the energy intensive minerals processing and all export gas activities are in the west and north);

- gas faces strong market competition:
 - in national energy markets from other fuel sources (abundant, low cost, high quality supplies of coal, relatively cheap coal-based electricity and renewable energy) all of which are advantaged by preferential fiscal treatment relative to gas, and
 - in export and import competitive markets, from an abundance of resources often with low development costs and access to project specific government support.

In relation to the wholesale and retail market:

- The retail market consists of less than 10 major energy retailers. The small nature of the market means that competitive pressures are likely to maintain this status well into the future.
- The number of producers active in the market is steadily increasing, but gas demand growth will be low until new base load gas-fired generation is taken up.
- Wholesale gas prices are a product of a number of factors, including competition with coal and gas-on-gas competition between producers. These prices are amongst the lowest in the OECD.
- Long-term contracts will continue to be an important feature of this small gas market so long as the number of energy retailers in the market remains low.