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Options for the development of the Australian wholesale gas market

Thank you for the opportunity to comment on the options for the development of the Australian wholesale gas market (the Paper). esaa supports the further commercial development of the gas wholesale market but is concerned about the prospect of government intervention to accelerate this development. Government intervention in the absence of genuine market failure delivers a more costly industry structure and therefore higher costs to end users. The Standing Committee of Officials has not demonstrated the presence of market failures that prevent or impede the further commercial development of the gas market. On this basis, and as options two, three and four, as detailed in the Paper, all require some degree of government intervention, the esaa must support option one – the current market with organic development.

Absence of market failure

The Paper rightly acknowledges that government intervention comes at a cost and should only occur in response to market failures, where the society-wide benefits outweigh the costs. It is in this context that the Paper poses the question "what is the role of government in wholesale gas market development going forward?" Ordinarily, this question would be answered by assessing whether there are any gas market failures that may require some form of government intervention. However, instead of demonstrating any failures within the gas market, the Paper makes a few cursory statements about "potential" market failures and proceeds to offer three options for government intervention into the gas market.

The Australian gas market has developed considerably in recent years with increased interconnection, a number of new retailers and significant pipeline and upstream investment. The Paper notes these changes and suggests that this has led to a more "dynamic gas wholesale market". With retail gas prices among the lowest in the developed world, it is difficult to understand how there could be such significant gas market failure that government intervention is required.

Liquidity of short-term markets

While the options were not developed in response to an identified market failure, the objective for each of the options appears to be the development of a “liquid spot and [short-term] contract trading market”. The Paper uses the gas markets within the United States and the United Kingdom as examples of “vibrant and liquid trading markets” that “highlight potential development opportunities for the Australian gas market”. However, the size of the Australian continent, coupled with a relatively low population, presents significant challenges for an integrated gas market. The Paper compares the United States with the non-Victorian gas wholesale markets and compares the United Kingdom to the Victorian market. However, what the paper fails to highlight is the differences in demand. Ultimately, it is demand that drives growth and liquidity. For similar geographic areas, the United States has a population of approximately 250 million (compared with 15 million outside Victoria) and the United Kingdom has approximately 60 million (compared with 5 million within Victoria). In addition, domestic demand per capita is much higher in the United States and the United Kingdom due to different climatic conditions. It is unlikely that the Australian gas market will ever achieve the sort of liquidity that is experienced in the United States and the United Kingdom.

Even within Australia, the nature of the market differs between jurisdictions. Victoria has an interconnected gas pipeline network with limited linepack storage capacity and a relatively higher proportion of residential demand, which experiences a greater degree of demand volatility due to changing weather conditions. VENCorp operates a wholesale market in Victoria to balance supply and demand in the presence of these market conditions.

The rest of the country is characterised by ‘point to point’ pipelines with relatively more linepack storage capacity. Further, gas is primarily used in manufacturing, mining and electricity generation. These characteristics, when taken together, make the demand schedules less volatile than in Victoria. This results in a reduced need for within day re-balancing. However, short-term trading in both gas and transport does occur on a daily basis so that market participants can optimise their respective positions.

esaa considers that a more liquid and formalised short-term gas wholesale market will develop when an entity or industry grouping identifies a commercial opportunity to promote such a market. This is likely to be a product of increased market maturity, reflected in a greater number of market participants, more complex portfolios and new sources of demand and supply. If governments were to intervene in an attempt to mandate such a market, as outlined in options two, three and four of the Paper, this could result in a costly framework with insufficient liquidity to support it. This would impose substantial costs on the industry, which would ultimately be borne by consumers.

The Paper highlights the numerous benefits of a more formalised short-term gas wholesale market. It is true that gas market participants may need options to adjust their positions and may wish to reduce transaction costs through a transparent pricing mechanism but the esaa contends that, in the absence of market failure, the market is best placed to determine the services it requires. If a more efficient market

structure exists, it is in the interests of participants to implement this structure to capture these efficiencies through lower costs. A more formalised short-term gas wholesale market will be commercially developed once there is sufficient liquidity to underpin it. It is important to recognise that it is liquidity that drives a market – not vice versa. To mandate a market mechanism, in the absence of sufficient liquidity, simply imposes an inefficient industry structure and higher costs on end users.

The Paper evaluates each of the options on the basis of a number of criteria, including efficiency. Government intervention, in the absence of market failure, is highly inefficient. As options two, three and four were not developed in response to clearly identified market failures, it is counter-intuitive that the options are evaluated as being relatively more efficient as the degree of government intervention increases. This calls into serious question the Paper's evaluation of each of the options.

Transparency

The Paper makes a number of assertions about transparency increasing liquidity - as a justification for mandating a market mechanism that would increase transparency (ie options two, three or four). In fact, the Paper goes so far as to state that "transparency and the **resultant liquidity** are, therefore, very important attributes of an efficiently functioning market." This is a rather curious assertion given that, later in the Paper, it is acknowledged that "it is possible that a transparent spot price will encourage further trading, but the Victorian experience to date would suggest otherwise."

The Paper also suggests that increased transparency is required to lower the barriers to entry into the gas market and to provide better price signals to new investment. The increasingly dynamic nature of the Australian gas market and the raft of new investments suggest that there are not significant barriers to entry for new investment. There are many products, across all industry sectors, which do not have formal "spot" prices or wholesale markets. The absence of a "transparent" wholesale market does not prevent new entrants from approaching potential producers or users with an offer, based on their own known costs or markets.

The Gas Emergency Protocol and the proposed Natural Gas Emergency Committee will develop arrangements for increased transparency of supply/demand and system capability information in the rare event that the gas market does fail – ie. during a gas emergency. The ordinary operation of the gas market should not be influenced by the extraordinary information requirements during a gas emergency situation.

Investment and increased liquidity

The key to driving gas market development and increasing the overall liquidity of the market is new investment. The Productivity Commission recognised this in their *Review of the Gas Access Regime* and noted the "potential for relatively small investments in interconnecting pipelines to increase the level of competition and to change how gas moves between sources of supply and end use markets"[1].

[1] Productivity Commission, "Review of the Gas Access Regime", (Melbourne: Commonwealth of Australia, 2004), pg xxvi.

esaa considers that governments' role in the development of the gas market should be focused on removing the current impediments to efficient investment and expansion of the market while decreasing the level of regulatory risk - through a commitment to a stable regulatory climate that recognises the presence of competitive forces in the gas market and improved, efficient and stable approval and permitting processes. However, the Paper states that "commercial entities should expect regulatory arrangements to evolve as the market itself evolves, in particular, to increasingly enhance competitive outcomes". As markets evolve and become more competitive, the degree of government intervention and regulation should reduce not "evolve to increasingly enhance competitive outcomes". It is this perspective that increases the likelihood of regulatory failure and significantly increases the regulatory risk faced by potential new investors.

A timely and comprehensive response to the Productivity Commission's report would go some way toward providing a more stable regulatory environment and encourage the investment needed in the gas sector. The suggestion within options two, three and four that "all transmission pipeline operators be subject to the non-price obligations under the National Gas Code" not only contradicts the Productivity Commission's recommendations but induces a degree of cost and risk for the owners of existing pipelines that are not covered by the National Gas Code.

Increased investment in the gas sector, resulting in additional transmission capacity and increased interconnection, would likely create the impetus for further commercial development of the gas wholesale market. Investor confidence, along with increased levels of demand, are the key to this development.

The Australian gas market is becoming increasingly dynamic. As the liquidity of the market increases, the further development of the existing wholesale gas markets will occur as market participants identify viable opportunities. This may take many forms, perhaps including bulletin boards, demand hubs, an industry wide spot market, or other mechanisms that provide the services that the market demands. However, for governments to intervene and mandate any of these options, in the absence of market failure and under non-emergency conditions, would impose a costly and inefficient industry structure that would be paid for by end users. Market development can be best supported by governments minimising regulatory intervention and creating a climate that supports future investment. It is on this basis that the esaa supports option one of the Paper – the current market with organic development.

Yours sincerely

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