

EXECUTIVE SUMMARY

Allens has released a discussion paper canvassing four options for development of the wholesale gas market. Option 1 involves continuation of the existing market. Option 2 involves mandated bulletin boards for each pipeline, with possible extension of the non-price provisions of the Code to uncovered pipelines. Option 3 involves setting of citygate prices for gas and/or capacity in each State, again with the option of extending the non-price provisions of the Gas Access Code to uncovered pipelines. Option 4 involves the extension of the VENC Corp model nationwide.

Enertrade supports option 1, which involves continuation of existing market arrangements and natural evolution to more sophisticated trading arrangements. The gas market is currently relatively immature, and it would be naïve to consider that imposing sophisticated trading mechanisms would of itself make the market more mature. The market is likely to evolve more sophisticated trading mechanisms over time as the benefits of doing so outweigh the costs. Such mechanisms may be closed off by hasty government intervention to force unwanted trading mechanisms on the market.

More importantly, no participants in the market have an incentive to constrain the introduction of such arrangements where they are desired by the market. Gas markets, and in particular, uncovered pipelines, have already attempted to introduce some of the trading arrangements suggested in options 2 to 4, with little market interest or acceptance by producers or users.

The Allens paper does not provide any reasons to justify the introduction of options 2 to 4. Common sense would suggest that in the absence of clear reasons for government intervention to develop the market, the prescriptions contained in options 2 to 4 are likely to be misplaced.

Option 2 will impose significant costs and overheads on market participants without providing significant benefits. Such costs have not been fully acknowledged in analysis conducted by Allens. A comprehensive and effective bulletin board facility would be costly, while a basic bulletin board would provide little information of value to participants. The information on trades posted on bulletin boards might be misleading since the parties posting it may have an interest in selective posting of information. In any case posted trades would provide little information of interest to other traders given the difference between posted trades and the trades they are seeking to execute. Imposing the non-price obligations of the Code on uncovered pipelines as part of option 2 would result in the costs of Option 2 being high, and would run counter to the recommendations of the Productivity Commission to reduce regulatory costs for pipelines, and to only impose the Code obligations on pipelines that meet the coverage test.

Option 3 provides no real benefits beyond the existing secondary trading arrangements in the Code for covered pipelines. Uncovered pipelines also have strong incentives to also permit secondary trading because it encourages access-seekers to enter long-term contracts by reducing the risks associated with doing so.





The proposal to price imbalances at day ahead citygate prices would kill incentives to contract for capacity where spare capacity exists in pipelines, since the presence of spare capacity would drive day ahead prices towards zero. This would fundamentally undermine the pricing of capacity.

Option 3 relies on increasing the depth and transparency of gas markets. However, it is unlikely to increase the number of market participants or their regularity of trading, as this is largely a factor of existing demand arrangements, which is for long-term, large volumes.

Option 4 is not justified as the costs significantly outweigh the benefits. Estimates would suggest the administrative costs of running a pipeline would double under the VENC Corp model.

In a more fundamental sense the need for the gas industry to transition towards a more market based model similar to the wholesale electricity market is unwarranted. The present bilateral or 'over-the-counter' arrangements work well in gas because:

- gas does not need to 'clear' instantaneously;
- user requirements are more predictable; and
- prices are set long term.

Allens presentation on its paper indicated that option 4 was proposed for the sake of completeness, and is not being considered seriously.

INTRODUCTION

The Australian gas industry has undergone significant restructuring since the mid 1990's. These reforms aimed to facilitate competitive supply arrangements and increase competition by addressing vertical integration, regulation and legislation prohibiting the trading of gas within and beyond State boundaries. With these reforms the Australian gas industry is growing and adapting.

To the extent there are remaining imperfections in the market, they are likely to arise from upstream and downstream concentration in market power, which may be exacerbated by limited diversity in the ownership of acreage and joint marketing arrangements among producers. The options for market development proposed in the Allen Consulting (Allens) draft paper do not address these imperfections but instead focus on increasing the regulatory burden in the already heavily regulated gas transmission sector.

The Allens paper has not cited any evidence to suggest Government intervention is required or will aid future development of the gas industry. Nor has the paper provided any rationale for how its proposals might address any perceived deficiencies in market structure. Overall, the Allens paper fails to paint a picture of the circumstances where government intervention might be justified – that is where a market seeking to develop, but that development is being held back by selected participants that have a strategic interest in current arrangements. There is certainly no reason to consider that pipelines, which are the target for the suggested interventions in options 2 to 4, have any incentive to retard market development, or are imposing constraints on the development of the market.

Enertrade considers that organic development of the market and trading mechanisms is likely to be superior to and market-oriented than government-imposed 'market development'. Under this scenario, developments in the market will come as the market



matures, and the benefits of introducing them exceed the costs of implementation. Forcing market mechanisms on a relatively immature market will not automatically 'make' it more mature; instead it will simply add costs.

Accordingly, Enertrade supports Option 1 where Governments do not intervene in the market and continue to leave it to the market to bring forward new trading developments and other innovations as they are supported by the market.

In this context, increased competition in the gas industry is best addressed by governments providing a regulatory climate that is conducive to new investment both in upstream production and gas transport infrastructure. Such an environment is characterised by regulatory certainty with respect to industry rules for wholesale and transportation markets.

OPTION 1 – CURRENT MARKET WITH ORGANIC DEVELOPMENT

Option 1 would involve a continuation of existing market arrangements.

The Australian gas industry has undergone significant and rapid change over recent years. These changes demonstrate the industry's trend towards deepening competition, increased transparency, new market entry and increased investment in gas infrastructure.

In recent years there has been a significant movement towards interconnection, which has facilitated increased competition in upstream and downstream markets, inter-basin competition, increased security of supply, and improved allocative efficiency. This has been evidenced by recent pipeline developments such as SEAGas. Further connectivity will come as new pipelines are developed.

This indicates that the future source of market development will come from greater pipeline development. Thus it is extremely disappointing that options 2 to 4 in the Allens paper focus on increasing the level of regulation of pipelines.

The number of new gas suppliers and sources of gas has increased over recent years providing increased competition. With recently signed contracts for supplies from Minerva, Patricia/Baleen, Yolla, Thylacine/Geographe, and coal seam methane there are five new firms supplying gas in the Australian market. Coal seam methane has increased its market presence in recent years through the need to source additional economic efficient sources of gas to meet growing demand. Further increases in demand for gas may be driven by changes in greenhouse gas emission policies.

Given the significant increases in gas consumption and the remoteness of gas reserves (excluding the Cooper basin and coal seam methane gas) it will be critical that consumers are able to source competitively priced gas in the future. The location of conventional natural gas reserves implies that future natural gas will be from gas fields located further away from a large proportion of the market. The costs of delivering gas will therefore be higher. All segments of the supply chain will be under increased pressure to ensure gas reaches these markets at competitive prices.

The Gas Access Regime has facilitated increased transparency for market participants. Section 5 of the *National Third Party Access Code for Natural Gas Pipeline Systems* (the Code) requires Service Providers to establish and provide prospective users with an information package. The information package contains general information on the terms and conditions of access, explains how to make an access request, and provides a public register of spare and developable capacity. Comparable arrangements have been



implemented by uncovered pipelines to promote greater throughput, for example under drafting of voluntary access principles.

To ensure non-discriminatory access and increased transparency Enertrade has released access principles for the Moranbah to Townsville pipeline, which are publicly available via our website. These principles ensure potential customers have comprehensive product information and certainty of treatment.

New uncovered pipelines offer these open access arrangements because they have incentives to maximise throughput on their pipelines in order to spread their large fixed costs over a broader customer base. This incentive also holds true for mature pipelines with relatively less spare capacity.

The gas industry has demonstrated its ability to identify market needs and create efficient market based solutions without the need for government intervention. There is no reason to consider that gas pipelines are imposing constraints to restrict natural market development or that gas pipelines have an incentive to impose such constraints.

The Productivity Commission's recent Review of the Gas Access Regime demonstrated the mistake of governments rushing to intervene in markets without carefully identifying the reasons for such intervention, and ensure that intervention will not come at a higher price than the benefits it seeks to deliver. This is demonstrated by the fact that uncovered pipelines are delivering a range of entrepreneurial products compared with the products offered by covered pipelines under the Code. For example, Duke Energy's Eastern Gas Pipeline (EGP) has posted a range of services it is willing to offer the market at any point in time that goes well beyond the services that covered pipelines are required to offer to the market. In the case of the EGP, Duke Energy entered into a range of different contracts for services, such as "firm forward haul, backhaul, park and lend, and even measurement services." (APIA, 2003:p72) Tariffs on uncovered pipelines are likely to become even more innovative over time, for example through more complex interruptible services, and risk-sharing proposals such as where tariffs are linked to the price that users achieve for their goods. The wide range of service offerings made available reflect the flexibility of the unregulated framework and its ability to react innovatively to meet the needs of the market. These innovations would not have been possible under heavy-handed code or Government mandated market development arrangements.

In recent years the majority of transmission pipeline development has taken place outside the Code and been driven by commercial incentives and expected tariffs. Such developments are largely premised on identifying a market opportunity and using entrepreneurial ability to fully contract pipeline capacity. Underlying such investments is the belief the investment will not be subject to regulation under the Code. Given the entrepreneurial nature of pipeline investment owners have generally built pipelines with excess capacity to facilitate future growth in demand. This is not the case for pipelines subject to regulation or likely regulation as new pipeline capacity is generally built to known demand to limit the scope for regulatory intervention to undermine commercial outcomes. Artificial arrangements such as the Code have hindered rather than encouraged competition and market penetration. Governments should be more cautious to intervene in markets, and more cognisant that intervention carries costs that may outweigh benefits or reduce entrepreneurial initiatives.

Moreover, examples from other industries demonstrate the benefits of allowing the industries to evolve naturally. The development of water markets in Australia (Box 1) illustrates that markets can evolve successfully through internally driven initiatives without



the need for regulatory intervention. The developments in the water industry also demonstrate that trading mechanisms that evolve through the participation and support of market participants are likely to be superior to those conceived and mandated by governments. In fact, the danger is that government intervention may close off certain market developments. For example, government intervention in the water market may have closed off development of one or both of the two trading mechanisms that have developed.

Box 1 Water Market Development

For many years following its formal inception in the 1980s, water trading largely occurred via transactions between individual parties or through brokers and agents, and without any formal entitlement exchange arrangements. In the late 1990s on-line water markets such as watermove.com.au and waterexchange.com.au were established by market participants.

The timing of these developments could be attributed to a combination of factors including increased trading activity and the uptake of internet technology by market participants, being mostly irrigation farmers. Government did not have a direct role in the establishment of these on-line exchanges; rather its role was limited to establishing the property rights framework that facilitated trading.

The development of these on-line exchanges has now evolved to the point where they are integral to the functioning of water markets, providing a mechanism for price discovery, increasing liquidity in the market, and reducing transactions costs for participants. The exchanges operate alongside over-the-counter transactions and local water brokers and agents.

The organic development of these on-line exchanges has provided diversity in the way in which water can be traded. For example, it has allowed two trading platforms to emerge. One platform (waterexchange.com.au) is a noticeboard-style exchange with buyers and sellers posting offers and transacting through the exchange. The second platform (watermove.com.au) provides a pool system for trades with periodic exchange dates.

The on-line water exchanges operate on a commercial basis and compete as stand-alone businesses. Competition has delivered choice to market participants, innovation in process improvements, and an expansion of offerings to include other traded products. There has also been entry into the trade facilitation market by water service providers.

It is significant that despite an objective of the COAG National Water Initiative being to improve water markets in Australia, little attention is paid to market facilitation and exchange. This implies that, at the highest policy level, the organic growth in water exchanges is accepted as being not only adequate, but favourable compared to an imposed market exchange structure. It therefore provides strong evidence of an effective market driven response to facilitate trading as part of a reform process.

The Australian gas industry is currently moving to improve customer service in a proactive manner. Further developments are likely to be driven by greater upstream production and pipeline development leading to broader trading and wheeling possibilities. These developments are likely in the long run to naturally meet the Ministerial Council on Energy's aims of greater transparency, new entry, and increased investment in gas production and supply, without the need for prescriptive, expensive and misplaced regulatory intervention.



In summary, Enertrade is not aware of any evidence to suggest government intervention is required or would aid future development of the gas industry. Further, no valid economic case for intervention has been presented in the Allens paper. Common sense would suggest that making prescriptions without identifying any underlying problem is not likely to lead to the best outcome.

Accordingly, Enertrade supports option 1 – continuation of the current market with organic development of trading mechanisms.

OPTION 2 – CURRENT MARKET WITH BULLETIN BOARD FACILITIES

Option 2 would involve the mandatory establishment of bulletin boards for pipelines, with a range of information to be provided, including at a minimum spare capacity, and allowing for voluntary (leading possibly to mandatory) posting of trades in capacity by sellers and buyers of capacity. The option might include imposition of the non-price requirements of the Code on uncovered pipelines.

Within the gas supply chain, information on reserves and production does not change quickly. At present, such information is collated by a number of groups including Government bodies such as ABARE. Ensuring such information is made publicly available in a timely manner has not historically been problematic and should not be difficult in the future. However, information on well head prices from upstream producers is not readily available and given the limited number of counterparties there are likely to be significant confidentiality issues associated with publishing detailed well head gas prices.

By contrast, the transport section of the supply chain is currently subject to either regulatory or commercial incentives to provide relevant information on spare capacity. This suggests that the emphasis in Option 2 on improving the transparency of pipeline information is misplaced.

It is unclear whether the requirement to establish bulletin boards will add any value to existing arrangements. At present, covered pipelines are required under section 5.9 to maintain a public register of spare capacity. Further, they are required under section 3.10 of the Code to provide for secondary trading of capacity. Thus, establishing bulletin boards that simply state spare capacity on an irregular basis will not add any value to existing arrangements. As discussed below, uncovered pipelines have similar incentives to advise on spare capacity and encourage secondary trading of capacity. For example, as further discussed below, Alinta currently provides a basic bulletin board service for uncovered pipelines where it posts any offers by existing customers to trade capacity.

Alternatively, it is possible option 2 could involve requiring pipelines to establish more sophisticated and dynamically-updated bulletin boards. Over recent years uncovered pipeline owners have made a number of attempts to establish and maintain more complex bulletin boards for their respective pipelines, for example Duke Energy (Box 2). In general, such arrangements have been short-lived or limited in scope due to the limited demand for the services provided, the ability of parties to trade privately, and the costs of dynamic updating.

**Box 2 Duke Energy Bulletin Board**

In June 1998, Duke Energy purchased the Queensland Gas Pipeline. At that time, Duke Energy indicated the intention to expand aggressively in Australia and to provide a full range of integrate energy services as they were doing in the US. One of the first steps in achieving this goal was to develop and implement an electronic (web based) capacity trading platform. This site was comparatively sophisticated in that it provided for either existing shippers or potential shippers to independently post capacity offers or requests and provided for a potential auction mechanism to establish a market clearing price for spare capacity.

This system was integrated with Duke Energy's internal operational and financial systems, resulting in a very sophisticated system but one that required ongoing maintenance in order to ensure its consistency with other electronic systems. The high cost of maintaining the system and the very limited demand for its services resulted in it being withdrawn in 2003.

The experience of Duke Energy in Australia illustrates that there needs to be significant underlying demand in order to justify the creation of a sophisticated bulletin board trading regime, and that forcing the establishment of sophisticated bulletin boards onto pipelines is only likely to reduce investor interest in building such pipelines in the future.

In this sense, Allens have underestimated the possible costs of establishing bulletin boards in their assessment of Option 2 compared with the base case of Option 1.

The reality is that bulletin boards are likely to play a role in facilitating market trading where there are a wide range of buyers and sellers who would not otherwise be able to contact each other to arrange trades. Given the relatively small size of the market at present, sellers and buyers are likely to know each other and arrange trades without government help. The need for bulletin boards is further reduced by the long term nature of market requirements for gas, which mean that trades happen relatively infrequently. Pipelines will have incentives to develop such services as the number of sellers and buyers in the market multiples, and trades occur more frequently. This will happen naturally with increasing interconnection of Australia's pipeline network and evolution in the nature of user demand.

Option 2 is unclear in terms of the information that it expects traders to post on bulletin boards. While it mandates the establishment of bulletin boards, it does not clearly spell out whether it will be compulsory for parties transacting deals through such bulletin boards to post information about trades on the boards.

One option would be to make it mandatory to post such information on the bulletin boards. However, in practical terms it would be impossible to enforce such a requirement. Moreover, requiring disclosure may well have the unintended consequences of reducing the likelihood of such transfers occurring due to concerns about posting commercially sensitive information.

On the other hand, option 2 may simply specify voluntary posting of trades on bulletin boards. This could well mislead the market by providing inaccurate information about trades. Firstly, parties may have strategic interests in posting selected trades on the bulletin boards but not others. For example, sellers of capacity may wish to post high priced sales of capacity in order to support future trades at high prices. The buyers of the same capacity may be content to see only high prices posted as this may discourage potential competitors from seeking capacity. Secondly, posted trades may be misleading because they do not contain all the contextual information necessary to understand them.



For example, parties may be happy to trade at very low prices because of undisclosed hedging or other arrangements.

In any event, information on trades is likely to be of very limited value to other market participants due to the thin nature of the market, the rarity of trades, and the different nature of other participants' interests. For example, posting a trade of interruptible capacity for the week ahead will provide no information of value to a buyer seeking a one year contract for firm capacity.

Present trading arrangements show there is little need for governments to force new trading arrangements on the market. Currently, pipeline capacity is being traded where necessary without recourse to established bulletin board services, for example the gas swap between Origin Energy Retail and a number of Cooper basin producers. The details of this swap were outlined in the Productivity Commission's Final Report on the Gas Access Regime (2003:p56):

Origin (Energy Retail) has agreed to deliver gas produced in its central Queensland fields to the producers at Roma in Queensland. The producers will then use this gas to meet part of their customer requirements in south-east Queensland. In return for the gas from Origin, the producers will redirect (swap) an equal quantity of Cooper basin produced gas to Origin at the Moomba gas hub ... Having access to swapped gas at the Moomba gas hub eliminates the need for Origin to construct major additional pipeline infrastructure in the short term.

Given the small number of upstream and downstream players such deals are relatively easy to strike.

It should be noted the gas transmission sector, through the Australian Pipeline Industry Association (APIA), has committed itself to the development of an industry Code of Conduct that includes a commitment to the provision of relevant information to the market together with offering tradeable capacity to the market. An example of the latter is seen on the Alinta web site for the Eastern Gas Pipeline (EGP). (In 2004 Alinta bought Duke Energy's Australasian assets including the EGP.) The EGP is an uncovered pipeline and Alinta, as part of its commitment to a Code of Conduct, includes information on currently available firm and as-available capacity together with a page dedicated to hosting available spare capacity offers from existing users.

This is an example of how the industry is currently moving to improve customer service in a proactive manner. These developments are being driven by greater interconnection and emerging competitive tensions that lead to new value added services (such as innovative services and tariff structures) and ultimately to a truly competitive energy market.

Allens paper also proposes that all transmission pipelines, including current non-regulated pipelines, might have to comply with the non-price obligations of the Code. The idea behind the Allens proposal is to facilitate the harmonisation of trading, nomination and balancing arrangements across the market and to ensure interoperability among gas transmission pipelines.

Enertrade strongly rejects this proposal. This would require uncovered pipes to adopt and have approved, new trading policies, ring-fencing arrangements, and information disclosure provisions. The irony of forcing these requirements on uncovered pipelines is that it is uncovered pipelines which have led the way in terms of developing services such as bulletin boards.



Such a suggestion is in direct conflict with the findings of the Productivity Commission on the Gas Access Regime (2003:p198), which stated that:

It is important to limit the application of the regime to those circumstances in which it is likely that the benefits of regulation outweigh the costs. The coverage criteria play a fundamental role in ensuring the regime is applied only in circumstances where it will achieve this objective.

The requirement to seek the relevant regulator's approval on an uncovered pipeline operator's trading policy will create significant regulatory costs and involve time delays as regulators consider and approve such arrangements. History shows that regulators have regularly delayed for long periods in finalising approvals. These delays would seriously undermine the ability of uncovered pipelines to conduct commercial negotiations and to facilitate investment in a timely manner. Moreover, uncovered pipeline would incur significant initial and ongoing costs in complying with these non-price obligations as they establish internal capabilities and systems which they do not currently require in order to conduct business. These costs and delays will flow through into increased pipeline tariffs.

More importantly, harmonisation will restrain a pipeline operator's ability to offer differentiated services. The arrangement proposed would be comparable to that under the Code where the services offered under the access arrangement are basically a one size fits all approach. Differentiated services are increasingly being sought by market participants. Also, the need for differentiation facilitates the innovation required to meet customer needs.

Option 2 will impose significant costs and overheads on market participants without the purported benefits. Such costs have not been fully acknowledged in analysis conducted by Allens. According to Table 6.2, the implementation costs of Option 2 compared to the base case are 'low'. This assessment fails to fully recognise the costs of establishing and maintaining a comprehensive and effective bulletin board facility. Irrespective of whether participation is voluntary or mandatory a base level of infrastructure must be implemented to facilitate the transfer of information. These costs are in the order of moderate to high. If the costs of requiring non-covered pipeline operators to comply with the non-price obligations of the Code, the cost of Option 2 is high.

OPTION 3 – CITY GATE SCHEME

This proposal would involve the creation of citygate hubs where gas or gas and capacity prices were posted on a daily basis. It is envisaged in the Allens paper that this would lead to the creation of a spot market in gas at these hubs. Imbalances (positive or negative) might be settled at next day's price. This option, like option 2, might involve the extension of the non-price provisions of the Code to uncovered pipelines.

Enertrade strongly opposes the introduction of option 3 as a model for the Australian wholesale gas market, and even more particularly where it involves the suboption of imposing the non-price obligations of the Code on uncovered pipelines.

A major problem with option 3 is that it has not been clearly developed and spelled out for interested parties to respond to. The Allens paper refers to a proposal put by the Electricity Retailers Association of Australia (ERAA), without specifying which details of the ERAA proposal Allens might take forward to the MCE. The ERAA proposal itself is not fully developed. Thus the danger might be that Allens advocates option 3 to the MCE when it is not clear whether option 3 could be developed into a feasible working model. In those



circumstances, the MCE might give in-principle support for the further development of option 3, and the market participants might find themselves bound to implement an option that ultimately proves not to be workable. More broadly, it is inappropriate for market participants to have to respond to a non-fully developed option 3, as it is difficult to identify possible issues with the option until it is more fully conceived and set out for consideration.

Having said that, Enertrade has identified a number of serious concerns with option 3 as described in the ERAA paper.

One aspect of the ERAA proposal that Enertrade is particularly concerned about is the proposal that imbalances might be priced at the day ahead citygate price of gas. This proposal has strong potential to seriously distort pricing structures in the gas market, and undermine incentives to contract for capacity. At present, capacity of most pipelines around Australia is significantly greater than current demand, especially for newly developed pipelines. Given the relatively forecastable load on pipelines, it is easy for market participants to predict whether next day will have spare capacity or not. In the presence of spare capacity overhanging the market, imbalance prices would tend to zero. Given market participants could predict spare capacity with a high degree of confidence, they would tend to minimise contracted volumes, maximise positive imbalances, and rely on zero or low day ahead prices to achieve free capacity for almost their entire load. This would cripple the revenues for existing pipelines, and kill off future development of new pipelines, as both critically depend on maximising contracted capacity in order to recover the high fixed costs of construction. The only way to counter this outcome would be to undersize pipelines in order to ensure there was no overhang in capacity. In these circumstances, pipelines would be able to drive imbalances to high levels, and encourage market participants to maximise contracted capacity and minimise imbalances. Either scenario would not reflect the true cost of delivery.

It should be noted that the presence of spare capacity is generally desirable, as it permits growth in demand without resulting capacity constraints. The mechanisms for pricing imbalances would punish pipelines for building spare capacity, and lead to undersizing of pipelines, and implementation of arrangements to minimise the ability to expand capacity.

There are other reasons why the imbalance pricing arrangements are unsuitable. The costs of imbalances vary significantly among pipelines, and are based on a range of drivers including the availability of line pack, spare capacity, pricing structures, and operational aspects around operation of compressors. None of these drivers relate to next day's prices. To substitute next day's citygate price for the true cost of imbalances would lead to a move away from the appropriate sharing of fixed and variable costs in imbalances replacing it with an unpredictable and arbitrary price that might not be set in accordance with true market signals.

More broadly, the citygate pricing arrangements are based on the assumption that spot prices are an effective signal for the development of the gas market. Spot prices work effectively when there is a multiplicity of buyers and sellers, and a homogeneous product such as in the electricity market. Despite the best efforts of market frameworks, they do not work in shallow markets like natural gas with few buyers and sellers, and varying requirements among participants. The number of buyers and sellers in the market is likely to be driven by factors other than the trading mechanisms. In particular, the number of sellers and buyers is likely to be driven by the large, long-term loads that constitute the vast majority of demand in the market (particularly outside Victoria). The reality is that there are simply too few sellers and buyers to take advantage of improved transparency and disperse the costs of establishing and maintaining Option 3.



Option 3 like Option 2 will impose significant costs and overheads on market participants without the purported benefits. Such costs have not been fully acknowledged in the analysis conducted by Allens. Given Option 3 requires a higher level of technological capability and information transparency the costs of establishing and maintaining a bulletin board will be high and not moderate as suggested by Allens. The quantum of costs will increase significantly if non-covered pipeline operators are required to comply with the non-price obligations of the Code, or if the imbalancing pricing arrangements were adopted.

Option 3 operates on the assumption that there are many potential lost opportunities to match buyers and sellers, and more sophisticated (but costly) market making mechanisms would improve liquidity. It also presumes that the market is incapable of setting up such mechanisms itself, or certain players are strategically blocking the establishment of such mechanisms. In fact, all players, especially pipelines, have strong incentives to set up such mechanisms. History has shown a number of attempts by pipelines (especially uncovered pipelines) to do so. These have failed where they have not been supported by sufficient depth in buyers and sellers. Imposing such mechanisms will not create liquidity in markets because it does not increase the number of buyers and sellers seeking to do deals.

Further the costs need to take into account indirect costs such as reduced incentives to invest or reluctance to develop pipelines with spare capacity. These costs have not been factored into the Allens analysis.

A key issue associated with Option 3 is that wholesale market participants (producers, users, merchant pipelines) may be required to obtain a Financial Services licence. This is due to the use of a financial signal (day ahead city gas price) to set the price of imbalances. The process of acquiring a Financial Services licence is an onerous requirement both administratively and financially. The costs of compliance – obtaining a licence, establishing administrative arrangements and reporting – are in the order of \$1 million. There are significant ongoing costs in maintaining a Financial Services licence.

Option 3 does not provide any benefits beyond the secondary trading provisions in the Code. These provisions deliver the benefits attributed to Option 3 without the costs or required regulatory arrangements that option 3 would entail. The secondary trading provisions already help to 'make' secondary markets in gas. For example, they facilitate current trading of gas without recourse to established bulletin board with posted citygate prices, as evidenced by the gas swap between Origin Energy Retail and some of the Cooper basin producers.

Moreover it should not be of concern that uncovered pipelines are not subject to the secondary trading arrangements in the Code, as they have strong incentives to permit secondary trading. All pipelines, and in particular new pipelines, wish to maximise long-term contracts for capacity in order to underpin development of such pipelines or their continuing viability. Permitting secondary trading increases the liquidity of capacity and encourages access seekers to enter such long-term contracts for capacity. In other words, by permitting secondary trading, pipelines (at no cost to themselves) reduce the risks faced by users when considering entering long-term contracts for capacity, and thus increase the amount of capacity that is likely to be contracted at any given price. This is why uncovered pipelines have strongly promoted secondary trading in the past, and in fact far more so than covered pipelines, which are more likely to be indifferent to secondary trading because they have regulated revenue streams that are less dependent on contracted volumes.



OPTION 4 – EXTENSION OF THE VICTORIAN MODEL

Enertrade does not support Option 4 as it will strongly increase current levels of regulation, regulatory uncertainty, and complexity.

There are two distinct market models implemented across Australia, market carriage and contract carriage. VENCORP operates the principal transmission system in Victoria as an independent system operator (ISO) using a market carriage system based on a net pool concept. All other States and Territories operate under the contract carriage system, involving bilateral contracting arrangements among sellers and buyers.

The Code reflects the underlying presumption of Government and industry that contract carriage is an acceptable model. This is demonstrated in section 3.8 of the Code where the regulator is prohibited from accepting an access arrangement which states the covered pipeline is a market carriage pipeline unless the relevant Minister has given notice permitting the covered pipeline to be a market carriage pipeline.

It is interesting to note that while Victoria has very specific issues which led to the original establishment of VENCORP, it appears in many ways the changes being proposed as a result of Victorian Gas Market Pricing and Balancing Review are seeking to move the Victorian Market more towards a contract carriage market.

The VENCORP model has not been implemented in the other Australian jurisdictions as markets outside Victoria experience:

- low price volatility;
- much flatter load factors due to the high proportion of industry demand as a proportion of total demand;
- less market players (sources of supply, pipelines, and users); and
- greater availability of line pack thereby reducing the requirement for an ISO to intervene frequently to rebalance supply and demand.

Adoption of the VENCORP model would impose unnecessarily costly arrangements on a market which is still relatively immature. In 2002-03, VENCORP's revenues attributable to recovery of the costs of operating the gas spot market, system security and gas transmission planning were in excess of \$12 million. This was in addition to the operating expenditure incurred by GasNet as owner of the principal transmission system. GasNet's underlying annual operating expense approved by the ACCC for that year was in the order of \$18 to \$19 million giving a total system annual operating expenditure for the Victorian Principal Transmission System in the order of \$30 million (VENCORP 2002-03 Annual Report, 2003:p31).

In terms of operating expense as a proportion of regulated asset value the costs of the Victorian system (at 6 per cent of asset value) were nearly double the equivalent costs for pipelines such as the Moomba to Adelaide Pipeline, which averaged around 3.2 per cent (APIA submission to MCE Consultation Paper, 2004:p11). These increased administrative costs were borne by users and would have led to reduced demand for gas by marginal users.

In a more fundamental sense the need for the gas industry to transition towards a more market based model similar to the National Electricity Market is unwarranted given the characteristics of gas supply, that is:



- gas does not need to 'clear' instantaneously. That is, it is not necessary for gas supply and demand to exactly equal each other at all times;
- user requirements are more predictable enabling users to confidently enter long-term contracts;
- prices are set long term and accordingly are less volatile;
- less market players facilitate the use of bilateral or 'over-the-counter' contracts rather than wholesale pool trades; and
- there is far less demand to contract short-term.

Enertrade strongly opposes the extension of the Victorian market carriage model as a model for the Australian wholesale gas market. It would impose major costs without a significant increase in benefits.

From the presentation that Allens gave on its paper, Enertrade understands that option 4 is not being seriously considered, but was proposed for the sake of completeness.

CONCLUSION

The Australian gas industry is currently moving to improve customer service in a proactive manner. These developments are being driven by interconnection, competitive tensions as companies strive to between utilise existing assets and create new value added services (such as innovative services and tariff structures) that promise to deliver a truly competitive energy market. This trend is naturally meeting the Ministerial Council on Energy's aims of transparency, new entry and investment in gas infrastructure without the need for prescriptive, expensive and possibly misplaced regulatory intervention.

The ongoing development of the market to date would suggest government intervention is not required to aid future development of the gas industry. The solutions proposed in the Allens report have not been presented with an explanation of the need for intervention.