

GAS MARKET LEADERS GROUP

FURTHER RECOMMENDATIONS ON A NATIONAL GAS MARKET OPERATOR

Introduction

The National Gas Market Development Plan sets out recommendations from the Gas Market Leaders Group (GMLG) for the formation of a national gas market operator.

The MCE in its communiqué dated 27 October 2006 requested a SCO working group to develop advice, for MCE consideration, on the GMLG proposal to form a national Gas Market Operator (GMO) to administer the Bulletin Board and Short Term Trading Market, including:

- the appropriate form of funding and governance arrangements; and
- whether to integrate the proposed GMO with the National Electricity Market Management Company.

SCO is to ensure that the GMLG will be consulted in the preparation of this advice.

The SCO acted on the MCE communiqué by establishing the Gas Market Operator Working Group (GMOWG). It is anticipated that a draft of the SCO GMO recommendations will be made available to the GMLG to consider in early February.

At its meeting on 27 November 2007, the GMLG established a Gas Market Operator Sub-Committee (Governance Working Group), with the terms of reference being:

- a. Develop options and recommendations for the GMLG's consideration on the governance and operational details of a GMO. Such initial advice is to be in time for the next meeting of the GMLG.
- b. Act on behalf of the GMLG in liaising with the GMOWG and ensure that the GMLG's views are conveyed.

The Governance Working Group further developed the recommendations in the National Gas Market Development Plan for a national gas market operator (separate to NEMMCO).

This Paper was largely prepared by the Governance Working Group and was endorsed by the GMLG at its meeting on 31 January 2007.

At the meeting it was noted that the establishment of a national energy market operator (EMO), encompassing electricity and gas, has been raised recently by the Energy Reform Implementation Group (ERIG). However, this Paper has been prepared on the basis of the status quo (i.e. a separate electricity operator (NEMMCO), with a Board largely constituted by jurisdictional representatives) and the immediate formation of a GMO, incorporating GMC, VENCORP and REMCO and with functions as detailed in the GMLG Plan (Appendix 1).

If active consideration is now to be given to forming a new energy market operator, then the GMLG recommends that the principles for a GMO, as detailed in the National Gas Market Development Plan and this Paper, are equally appropriate for an EMO.

The GMLG recommended (in June 2006) that a GMO be established as soon as possible. It is expected that a decision on whether or not an EMO is to be established will take considerable time - and this is a debate that the gas industry and GMLG would need to join.

Hence, it is strongly recommended that a GMO be established now and, as noted in the National Gas Market Development Plan, “there be close contact and cooperation between the new Gas Market Operator and NEMMCO to ensure that any efficiencies are realised and common approaches are taken wherever possible”.

1. Statutory Entity

The proposal in the GMLG National Gas Market Development Plan states:

“The Market Operator should be established as an independent entity under statute but incorporating the rules of corporate governance. The use of a statutory entity avoids any possible complications from the Trade Practices Act and reinforces the independence of the entity;”

“the Board of Directors will be subject to Ministerial Direction only in the event of emergency gas situations”.

Recommendations

1.1 Suitability of the Form of the Gas Market Operator

Given

- the nature of the work to be performed by the market operator, which is necessarily more complex than any of the existing market operators and relevant to multiple jurisdictions, encompassing the scope outlined in Appendix 1,
- the desirability of exemption from authorisation requirements of the Trade Practices Act and
- the desirability of statutory indemnities for the market operator and its directors

a statutory entity remains the preference of the GMLG.

However, should the MCE SCO determine that a corporate entity is more appropriate, it is recommended that this be accepted by the GMLG, preferably with appropriate statutory exemptions to avoid the necessity for an authorisation under the Trade Practices Act, and appropriate statutory indemnities for the market operator and its officers.

1.2 Accountability to Government

The national market operator must have formal accountability to the MCE for the operation of the market.

A significant level of accountability is achieved through the requirements that the rules governing the market be made by the AEMC, and that regulatory oversight in the form of economic regulation and licensing control of market participants is placed with the AER.

In that context, the mechanisms which have ensured open and transparent operation of the market for the existing market operators should be replicated for the national market operator. Accordingly, it is recommended that the following measures be adopted:

- Objectives and principles of the market operator will be subject to MCE approval in the first instance, and will not be changed without the consent of the MCE –the objective of the market operator will be limited to the market operation defined in the statute, and governing principles such as efficiency of operation, non discrimination between market participants, minimising barriers to entry to the market, ensuring that the markets deliver net benefits to consumers, will be set out in the statute to guide the Board in its decision making processes.
- Total transparency of operation to MCE – agreed documents will be provided on a regular basis (eg Board papers, Board minutes, financial reports) and all documents will be available for government perusal.
- MCE will have a right to an observer at all Board meetings and committee meetings of the market operator.
- Annual Reports, Corporate Plan, Financial Statements will be provided to MCE.
- MCE and/or Ministers will have a right of direction in emergencies only.

1.3 Accountability to Industry

The national market operator must be accountable to the gas industry for the design, implementation and operation of an efficient and cost effective market. The Governance Working Group considered various mechanisms for achieving such accountability for a statutory entity whose directors are required to act in the best interests of the entity, within the objectives and principles specified in the statute. The following recommendations are premised on an industry appointed Board and would need to be revised should that proposal be significantly varied.

It is recommended that the existing proposal in the National Gas Market Development Plan that the Board of Directors be appointed by industry, with independents subject to MCE approval, provides an appropriate level of accountability to industry for the market operator. The market operator should be required to operate in a transparent manner so that the market is properly informed of the information which would be available to it if a corporate entity had been established.

It is not considered necessary to replicate the membership rights which might apply to a corporate entity in the proposed statutory entity. It would be anticipated that, given the nature of the Board, widespread consultation with industry will occur where appropriate. In addition, market participants will have direct and ongoing rights in relation to the adoption and change of the rules which govern the market. Accordingly, there would appear to be very few matters in respect of which the rights of membership of a company would be appropriate or necessary. It was also considered that the lack of strong precedent for membership rights in a statutory entity would make such a proposal less appealing to government.

For similar reasons, it is considered unnecessary to determine a list of matters which the Board of Directors should be required to refer to industry for decision.

2. Board of Directors

The proposal in the National Gas Market Development Plan states:

- “the Board should consist of a majority of Directors nominated from, and voted on by, market participants, with the remaining Directors being independent of the gas industry, nominated by market participants but subject to approval by the MCE;

- other than the independents, Directors will be selected on the basis of nominations from the various sectors of the gas industry which will ensure a balance of gas industry knowledge and experience;
- Directors will be required to act in the best interests of the Market Operator, and according to the principles of market design and operation set out in the statute;
- the Chair should be appointed from the independent directors, nominated by the market participants but subject to approval by the MCE.”

Recommendations

- The Board of Directors will consist of a maximum of nine directors, being three independent directors (including the Chair) and six directors appointed from industry.
- To ensure that the Board has an appropriate breadth of industry knowledge, industry will appoint directors who collectively will provide expertise across the industry sectors
 - Retailers
 - Wholesalers
 - Distributors
 - Pipeline Owners/ Operators
 - Producers
 - End Users
 - Gas fired generators
- It should be noted that once appointed, directors will not represent their individual segment, but will be required to act in the best interests of the entity.
- In respect to the independent directors, a Selection Committee will be established by the Board to consider nominations. Any industry body may nominate an independent director to the Selection Committee, which will consider that nomination against a predetermined skill set requirement and the current membership skills of the Board. The Panel will determine an agreed independent nomination(s), which will be submitted to the MCE for approval.

- An independent director is independent of management and free of any business or other relationship that could materially interfere with – or could reasonably be perceived to materially interfere with – the exercise of their unfettered and independent judgment (ASX Principles of Good Corporate Governance and Practice Recommendations).. Overall, the Board would benefit from skills in the areas of finance, executive management, legal or regulatory experience, IT. Industry expertise would provide an additional advantage in an independent director. In any given circumstances, the skills sought in the independent directors will depend upon the skill sets of the industry appointments, although as directors will presumably retire by rotation as a percentage of the Board, appointments to fill a particular gap may only be relevant for a short time period

The Governance Working Group considered the following issues in reaching these recommendations:

- The issue of whether small new entrant participants should be given specific representation on the Board was considered. However, with the protections of the rule change process, the regulatory oversight of fees and ultimately compliance, and the inclusion of three independent Directors on the Board, it was not considered necessary to provide for specific representation.
- The issue of whether directors should be appointed on a jurisdictional basis (eg, NSW, VIC, WA) was considered. As one of the objectives of the national market operator is to establish and operate a consistent national market, it was determined that jurisdictional considerations were not appropriate in the appointment of directors, but could be presented through industry appointed directors.
- The issue of whether those industry sectors more directly affected by the operation of the market should have greater representation on the Board was considered, or whether resolutions should be required to include specific sector support.

For example, it is arguable that retailers and wholesalers would have a greater interest particularly in costs incurred, the imposition of fees, and decisions leading to fee increases, given they will likely bear a proportionally greater share of these costs, and subject to rights to recover these fees, end users may have the same considerations. However, should the directors from these sectors consider that any

such proposals at the Board were contrary to the interests of industry generally as well as contrary to the interests of retailers, wholesalers or end users, they would have the opportunity to obtain the support of other industry directors and the independent directors.

Overall, it was considered that the proposed Board composition would be adequate to ensure that decisions did not unfairly impact any particular sector.

The Working Group is further considering the director selection process and this will be the subject of another paper.

3. Rule Making

The proposal in the National Gas Market Development Plan states:

- “The regulatory framework would consist of the MCE establishing overall policy outcomes, the AEMC approving the rules, the Australian Energy Regulator (AER) providing regulatory oversight and the Market Operator managing rule development, implementation and market operation.
- The MCE would establish the policy for gas markets nationally, probably through the National Gas Law and Gas Rules and through statements of policy principles.
- The AEMC would consider and approve the rules for the wholesale and retail markets (which may be on a State basis), subject to procedures established under legislation such that:
 - The initial rules are developed through the Market Operator, via its industry working groups, consultation processes and Board determination, in the context of the policies established by the MCE.
 - The rules would require approval by the AEMC prior to implementation and should the AEMC determine that the proposed rules fail to meet the policy established by the MCE, they would be referred back to the Market Operator for further development, until satisfactory.
 - The decision of the AEMC will be final.

- Rule change proposals would be initiated by the Market Operator, which will be required to consider changes proposed by market participants and jurisdictions. The Market Operator will develop and consult on proposed rule changes prior to the decision of the Board to submit these to the AEMC. The AEMC could accept or reject a proposed rule change, based on its assessment of the impact of the proposal on the achievement of policies and principles established for the gas market by the MCE.
- The objective will be to implement rules and a rule change process that provide for AEMC decision making on matters of principle or policy, but avoid unnecessary and costly duplication of industry and AEMC consultation processes, and allow industry, through consultation procedures managed by the independent Market Operator, to address technical, operational and procedural matters that have no impact on policy or market principles.
- The existing VENC Corp, GMC and REMCo rules would be grandfathered.”

In the MCE Energy Market Reform Bulletin 77, the SCO released an exposure draft of the Electricity Amendments and further amendments to the electricity and gas rule-change process including a description of further amendments to the gas and electricity rule change process. In general, the SCO proposals were consistent with the GMLG recommendations, with the exception that GMLG had recommended that rule changes be initiated only by the Market Operator, where the SCO proposal allows any person to apply to the AEMC for a rule change. SCO has invited submissions on the exposure draft by 22 February 2007.

Recommendations

The GMLG will respond to the exposure draft reiterating its view that the market operator should initiate and consult on rule changes prior to submission to the AEMC for approval, with the requirement that the market operator consider and progress a rule change sought by any person, rather than also allowing rule change nominations to the AEMC. This represents the preferred position of the GMLG as previously stated.

In practice, it is likely that virtually all rule changes will be sought by market participants raising problems with the rules within the market operator industry working groups. Existing industry working groups have demonstrated that they can efficiently design rule changes to resolve

issues raised by market participants, obtaining the support of all market participants in that process.

Therefore, given the likelihood that market participants will proceed through the market operator rule change process in any event, the GMLG would accept a decision by the MCE to retain the proposal in the exposure draft that allows any person to propose a rule change directly to the AEMC, provided the AEMC then referred that proposal to the market operator for consideration through its consultative processes.

It is noted that the proposal to grandfather the GMC /VENCORP /REMCO rules does not intend to provide any greater power to the market operator in respect to those rules than is already incorporated in them.

4. Compliance

The proposal in the National Gas Market Development Plan states:

- “Compliance issues and disputes should be dealt with initially through efficient, cost-effective processes managed by the Market Operator, without unnecessary involvement of courts or regulators.
- The AER would oversee gas market compliance. It is noted that the governance structure of the Market Operator, with industry and independent representation on the Board, provides a robust built-in mechanism for ensuring costs are minimised and fairly attributed.”

Recommendations

It is recommended that the “efficient, cost-effective processes” for dealing with breaches of the rules mirror the existing compliance structures in place in NSW, ACT, WA and SA markets (VENCORP does not deal with compliance issues).

- The market operator will be given the requirement to enforce the rules, to facilitate an immediate response to alleged breaches of the rules.
- Every rule breach will be considered by the market operator to determine whether it should be referred to the Independent Compliance Panel. In order to carry out its referral role in an equitable and transparent fashion, the market operator will adopt

Compliance Guidelines stating the factors which it will consider when deciding whether to refer a breach to the Panel, and the rights of a market participant to put their case to the market operator. The market operator's determination on whether to refer an apparent breach, and the reasons for that decision, will be published to all market participants and stakeholders.

- The market operator will establish an Independent Compliance Panel consisting of 5 members, a chair with legal qualifications and industry experience, two experts with financial experience and two experts with technical and industry experience (3 of whom sit at any hearing). These members must be independent of any market participant. The Panel can be called together quickly to deal with any breach. The Panel will adopt comprehensive hearing procedures so that participants can be fully prepared for any hearing.
- The Panel will consider any rule breach referred to it by the market operator, and has the power to require action or the cessation of action by a participant, impose penalties up to \$50,000, and in some circumstances to suspend the participant from the market and/or refer the conduct of the participant to the AER for consideration as a breach of licence or statutory requirements. There is no appeal from the decision of the Panel.

It is recommended that a dispute resolution procedure be established in the rules, to allow market participants to resolve situations where one has suffered loss due to the failure of another market participant to comply with the rules.

- This requirement is necessary because the rules cannot be separately acted upon by the market participants.
- It is anticipated that this procedure would be outsourced to an existing national dispute resolution entity.

It is recommended that the AER administer compliance with any statutory requirements and licensing requirements.

Appendix 1: Outline of Scope of National Gas Market Operator

Bulletin Board:

- detailed specification of information requirements and protocols;
- initial development and implementation of the Bulletin Board facility;
- facilitation of interfaces with those parties required to supply and update information; and
- ongoing maintenance, updating and operation of the Bulletin Board.

Short-Term Trading Market:

- development and administration of the detailed trading rules;
- initial development, implementation and maintenance of STTM systems;
- facilitation of participant interfaces;
- daily collection of bids/offers and forecast withdrawals;
- construction of the daily bid-stacks;
- setting the daily clearing prices;
- notifying shippers of cleared delivery and withdrawal quantities;
- collection of metering data and/or overseeing delivery and withdrawal allocations to shippers and users;
- monitoring of market exposures and management of prudential requirements;
- financial settlement of the market; and
- collection, assimilation, publication and distribution of system and market information (including aggregation of demand information where appropriate and practical, in order to provide commercial confidentiality to single large end-users).

NGERAC support:

- collection, maintenance, reporting and analysis of gas system and market information; and
- provision of other services as required by NGERAC in relation to planning for, or management of, potential or actual gas emergencies.

Gas supply/demand statement:

- preparation of a national annual gas supply/demand statement, similar to the SOO and APR of NEMMCO and VENCORP, respectively.

Gas retail market arrangements:

- operation of the gas retail market arrangements in NSW/ACT (currently performed by GMC), SA and WA (currently performed by REMCO), Victoria (currently performed by VENCORP) and QLD (to be performed by VENCORP); and
- planning for, and future operation of, gas retail market arrangements in other States and Territories.

Gas Market and Network Operations in Victoria (currently performed by VENCORP):

- operation of the Victorian gas market; and
- operation of the principal gas transmission system in Victoria.