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Independent Market Operator
Attn: Group Manager, Development and Capacity
PO Box 7096
Cloisters Square, Perth WA 6850

Lodged (by email): market.development@imowa.com.au

Development of a wholesale gas market in Western Australia

The Energy Supply Association of Australia (esaa) welcomes the opportunity to make a submission to the Independent Market Operator's (IMO) consultation on the development of a wholesale gas market in Western Australia.

The esaa is the peak industry body for the stationary energy sector in Australia and represents the policy positions of the Chief Executives of 34 electricity and downstream natural gas businesses. These businesses own and operate some \$120 billion in assets, employ more than 51,000 people and contribute \$16.5 billion directly to the nation's Gross Domestic Product.

The Western Australian domestic gas market has had to compete with Australia's lucrative liquefied natural gas (LNG) export industry for some time. This is principally due to the extensive gas fields located off the Western Australian north-west coast requiring a scale of operation in excess of that needed to satisfy domestic demand. While this has historically provided domestic customers with access to gas – subject to some form of government intervention – the expected fulfilment of the North West Shelf (NWS) domestic supply obligation in 2020 could potentially challenge domestic supply dynamics relative to business-as-usual.

In light of this, there is currently renewed focus on the adequacy of existing gas market arrangements in Western Australia. A prime example of this is the Gas Advisory Board's request that the IMO consider the merits of a gas and capacity trading mechanism in Western Australia. The driver in this instance was not that current market arrangements are insufficient for the industry's requirements. Rather, that there is merit in exploring how the expiration of long-term contracts over the period to 2020 may deliver a greater volume of gas and capacity that could potentially be traded through some form of short-term trading market mechanism.

The existence of a range of wholesale gas market rigidities specific to Western Australia has constrained the development of a competitive, transparent and secure domestic gas market. Current characteristics of the Western Australian wholesale gas market include: limited diversity of supply; infrastructure capacity constraints, limited price transparency; and increasing energy costs.

In recent years, a number of initiatives have been pursued, supported by the findings and recommendations of the Gas Supply and Emergency Management Committee's report to Government and the Inquiry into Domestic Gas Prices. These include the development of a Western Australian based Gas Bulletin Board (GBB) and Gas Statement of Opportunities (GSOO), as well as investment in additional gas storage at the Mondarra Gas Storage Facility.

Despite this progress, the development of further competition in Western Australia's wholesale gas market is still potentially inhibited by: authorisation for joint selling and marketing; management of retention leases; a lack of price transparency; and a lack of responsiveness and flexibility in gas transportation.

The ability of the Western Australian gas market to efficiently respond to changing market dynamics will be dependent upon the access to, and flexibility of gas supply agreements and wholesale trading market arrangements and settings. Greater market transparency is likely to contribute to improved market dynamics in this respect, which suggests there is potentially a role for some form of facilitated trading platform. It could also influence future joint marketing authorisations, since market development and competition are key considerations for the Australian Competition and Consumer Commission (ACCC).

But addressing the desire for more transparent and shorter-term price signals in an established market like Western Australia is not without its challenges. There are trade-offs associated with trying to enhance particular market attributes. This may include increased compliance costs that will ultimately be passed on to end-users as well as commercial risks for those businesses that have underwritten current arrangements. It is also unclear that market intervention would deliver the efficiency gains necessary to justify the associated costs.

These factors appear to have been considered to some degree in the development of the voluntary base and extended hub models, with the guiding principles giving specific consideration to: minimising costs; avoiding the requirement to change gas pipeline arrangements; and minimising system impacts on participants. But the absence of detailed analysis around the cause and extent of any perceived market failure, or indeed the costs/benefits of either approach, makes it difficult to explicitly evaluate options at this stage of the consultation process.

An incremental approach to gas market reform that has appropriate regard for existing contracts is likely to be the most appropriate response. Such an approach provides a better balance of risks/benefits relative to more heavy-handed reform and would likely be consistent with supporting industry-led reform. Further, the appropriateness of any government/regulatory intervention should ultimately be guided by consideration of: the nature of any perceived market failure in the context of the Western Australia gas market; and how alternative arrangements will deliver net benefits for consumers over the long term.

Understanding the nature of market impediments is essential

It is recognised there are concerns that the existing market structure may undermine opportunities for flexible gas trades due to a lack of information around short-term

pricing and availability. Further, it is clear that a liquid and flexible market for gas supply and/or pipeline capacity has not developed in Western Australia.

The extent to which the current framework may impede short-term trading opportunities and thus, efficient gas supply and infrastructure utilisation, is not immediately evident. Market participants and pipeline operators face clear financial incentives to offer unutilised gas volumes and pipeline capacity where there is demand and there are mechanisms available that enable these parties to complete such trades. This includes spot trading through market-based platforms developed by Gas Trading Australia and Energy Access in response to industry needs.

The absence of liquid and flexible markets for short-term trading does not necessarily imply there is a market failure or that current market settings are inefficient. Rather, a lack of trading could potentially be reflective of a number of factors, including the physical nature of lengthy pipelines that negate the need for short-term balancing requirements relative to some other markets.

Nonetheless, as discussed, flexible and transparent access to supply and capacity is important for the development of liquid and transparent commodity markets. Where access to supply and capacity is impeded, therefore, this creates a risk that incremental benefits of more flexible short-term trades are missed, the value of which may grow as market dynamics continue to evolve.

To inform discussion, it is important the IMO's consultation process provides a more detailed assessment of potential impediments to short-term trading (e.g. is it a lack of demand, administrative complexity, or absence of information) as well as the materiality of the issue more broadly. Identifying and understanding the nature of any perceived market failure is a prudent first step that will guide the appropriateness of any market intervention and assist in driving industry-led reform.

Market intervention must be carefully considered

In the absence of detailed analysis around the cause and extent of any perceived market failure, it is difficult to explicitly evaluate options at this stage of the consultation process. The Electricity Market Review also gives specific consideration to market Governance arrangements for Western Australia, which makes commenting on market operator arrangements challenging. To this end, the Association has provided some general observations with respect to the direction of gas market reform and the degree of intervention that could be considered in the context of the Western Australian gas market.

Flexible and transparent access to gas supply and transportation capacity is a key feature of well-developed gas markets globally. In such markets, the benefits of transparency and liquidity are interrelated and reinforcing. Transparency improves efficiency and security of supply as market participants become increasingly aware of the value of gas at different locations and at different times, while liquidity facilitates competition and enhances efficiency by enabling markets to react to an increase in transparency.

The characteristics of the Western Australian gas market (e.g. limited upstream competition, reliance on long-term bilateral contracts, modest domestic demand etc.)

may slow natural evolution towards more transparent and shorter-term arrangements for supply/transportation to some degree. But this is not justification for a heavy handed approach to reform. Rather, it highlights the need for a strategic but light-handed approach that addresses potential barriers to industry innovation and is conducive to market development.

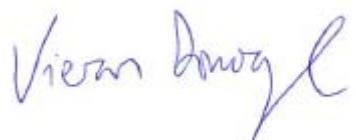
On this basis, the esaa considers there is merit in exploring the basic model framework. This model appears to provide a better balance of risks/benefits relative to the extended model – minimising the level of regulatory intervention by avoiding distortions to existing contractual arrangements while also potentially enhancing the visibility of short-term trading opportunities. But the Association would make the following observations.

- Given the absence of clearly defined deficiencies in existing market arrangements, it is difficult to assess the potential impact of the supply hub model and how it would contribute to better achieving the National Gas Objective (NGO) in the context of the Western Australian Gas Market.
- The limited size of the domestic gas market in Western Australia may provide a barrier to trading and liquidity on the facilitated market, particularly since long-term bilateral agreements remain the primary mechanism for establishing a sustainable position in the market and managing risk. The marginal uptake of trading services provided by Gas Trading Australia and Energy Access should be taken into consideration in this regard.
- The costs of administering the gas supply hub may not be completely recoverable from a variable charge applied solely to hub participants. This may require cost-recovery from the broader shipper base, consistent with the allocation of costs for the IMO's GBB and GSOU. The esaa considers it would be inappropriate to require those participants who are not actively utilising the facilitated trading hub to subsidise its use. This raises the question as to who would finance the facilitated market, particularly if it is not an industry led initiative.
- The physical characteristics of the Western Australian gas market (e.g. several lengthy pipelines) may negate the need for facilitated daily balancing services. On this basis, it seems appropriate that balancing services are excluded from the base model.

The IMO's consultation could play an important role in the future development of a facilitated gas trading market in Western Australia. But the decision to proceed with any such development should ultimately be guided by industry and informed by independent cost/benefit analysis where possible. Such an approach will ensure that market reform occurs occur where there is need and deliver important market benefits without any associated regulatory burden and the costs these entail. The process is one of evolution and the Association welcomes further work in this regard.

Any questions about our submission should be addressed to Shaun Cole, by email to shaun.cole@esaa.com.au or by telephone on (03) 9205 3106.

Yours sincerely



Kieran Donoghue
General Manager, Policy