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Eastern Australian Domestic Gas Market Study

The Energy Supply Association of Australia (esaa) welcomes the opportunity to make a submission to the joint Department of Industry and Bureau of Resources and Energy Economics Eastern Australian Domestic Gas Market Study.

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 esaa is strongly supportive of developing a forward reform agenda for the east coast gas market. Significant gas market reform has been undertaken over the past 20 years and market development is ongoing. The study provides a timely opportunity to reassess priorities and goals and ensure the market is well placed to deliver efficient outcomes for both market participants and end-users over the long term.

Australia is naturally endowed with significant reserves and resources and has historically benefited from the provision of secure, reliable and reasonably priced gas supply – relative to global standards – for some time. While gas is poised to continue playing an important role in the future of Australia's energy supply industry, the market is in a state of transition. Production costs are rising, political uncertainty is hampering onshore gas development in a number of regions and new demand from the liquefied natural gas (LNG) industry is changing gas market dynamics. Coupled with the absence of shorter-term price signals, there are concerns over the future availability and price of domestic gas supply.

In light of this, there is currently a heightened government focus on the east coast gas market, particularly with respect to enhancing transparency through an increasing role for markets. This interest is exemplified by the range of reviews undertaken by multiple jurisdictions, departments, agencies and industry association over the past 12 months.

Though it is currently unclear how the east coast gas market will adjust to these new pressures, market intervention to force domestic outcomes is not the answer. Rather, it is important that efforts are focused on stimulating resource development and exploring ways to enhance competition and drive efficiency gains across the broader east coast gas market, as discussed below.

Stimulating resource development

As evidenced in the modelling analysis underpinning the study, there is sufficient supply to meet both domestic and export demand over the outlook period. A key priority for government in this regard is to stimulate gas resource development with a view to maximising diversity of supply. New South Wales serves as an example of the problems that could emerge across the broader east coast market unless appropriate policy settings are in place for the exploration, production and supply of gas.

To ensure gas resource development is sufficient to support both domestic and export demand in the future, it is critical that government policies relating to the exploration and production of unconventional gas resources are carefully considered. In particular, government policies should give adequate consideration to the concerns of local communities, but also focus on the key role natural gas plays in the Australian economy, both in terms of value creation and as an essential service. Initiatives to reduce duplicative and often inconstant state and federal requirements should also be supported.

Encouraging market development

Information transparency and liquidity are key features of well-developed gas markets globally. To the extent these features are yet to fully develop in the east coast gas market, this does not necessarily imply there is a market failure or that investment has been inefficient. But it is still important to explore how these attributes can be enhanced across the domestic supply chain.

Addressing the desire for more transparent and shorter-term price signals in an established but evolving market is not without its challenges. There are sovereign risks to be considered where the rights of existing market participants are potentially compromised. This creates significant regulatory risk, the implications of which could impact upon future levels of investment. Further, it’s not clear that implementing some form of intervention would deliver the efficiency gains necessary to justify any associated costs.

On this basis, a light-handed and incremental approach to reform that has appropriate regard for existing contracts is likely to be the most appropriate response. Efforts to improve information provision and potentially reduce transaction costs across the supply chain would be a good starting place in this regard. 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 initiatives such as the ‘trade facilitator’ model currently under development.

More detailed commentary relating to the above reform priorities and other related issues is provided for consideration in Attachment 1. Addressing these issues will require a coordinated effort by governments and industry, but there is a clear role for the Commonwealth in engaging with stakeholders to develop and coordinate the most efficient path forward.

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

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Attachment 1

I. Gas market reform agenda

The east coast gas market has undergone significant transformation over the past 20 years. Bilateral contracting has facilitated investment in production/transportation infrastructure and connected regional demand centres with multiple supply points; competition in retail markets has emerged; and facilitated trading markets have been developed to provide a transparent and market based mechanism for managing daily imbalances.

While it is expected the east coast gas market will continue to evolve over time, price and supply uncertainty associated with changing market dynamics has brought with it a renewed focus on the appropriateness of existing market arrangements. In particular, there is evidence of a desire for more transparent and short-term price signals across the supply chain and more diverse mechanisms for managing pricing risks (i.e. forward trading).

A range of ongoing government initiatives have been established with the aim of enhancing elements of the east coast gas market, as outlined in the Australian Gas Market Development Plan. While it is important these processes are progressed and completed, a more strategic approach to reform that considers the broader east coast gas market and clarifies the overarching reform objectives/principles is needed. The government would be well placed to deliver this – in consultation with stakeholders – through the establishment of a forward reform agenda.

The Association considers the National Gas Objective suitably articulates the objectives of the east coast gas market and that the proposed gas market principles seem broadly appropriate to guide future reform. Consistent with these principles, two priority reform areas in the east coast gas market (discussed in more detail throughout this submission) include:

- stimulating resource development to mitigate supply and cost pressures for consumers over the short and longer term; and
- improving market transparency and access to information across the supply chain, while also having regard for existing investments and arrangements.

Identifying and exploring policy options to address reform priorities – particularly with respect to improving market transparency – is challenging in an established but evolving market. There are sovereign risk issues to be considered where the rights of existing market participants are compromised or impeded and there are costs associated with delivering transparency.

Given these risks and the interrelationship between commodity and transportation arrangements, it is important that any reform strategy is carefully considered and takes a holistic view of the market. To this end, the Association is not supportive of reviewing discrete elements of the market in isolation. Rather, an approach that enables government and industry to work through practical solutions in the context of the broader market is appropriate and would likely provide for a more strategic assessment of reform opportunities.

A number of market reforms and industry-led initiatives are currently at various stages of implementation and it would seem sensible to provide market participants with time to adjust to these new arrangements prior to considering whether yet another formal review is warranted.

II. Promote gas supply competition

Continuing to drive upstream competition is fundamental to a well-functioning east coast gas market. A key reform priority for governments in this regard is to promote gas resource development with a view to maximising diversity of supply.

Delivering policy certainty and removing barriers to supply

The development of unconventional gas reserves and resources has been constrained on the east coast to date, principally as a result of political uncertainty and overly restrictive planning laws and regulatory frameworks. Such an environment has severe implications for the timeliness and diversity of supply, as it creates barriers and risks to investment at a time when continued resource development is essential. New South Wales is at the forefront of this issue and serves as an example of the problems that could emerge across the broader east coast market unless appropriate policy settings are in place for the exploration, production and supply of gas.

To ensure gas resource development is sufficient to support both domestic and export demand in the future, it is critical that government policies relating to the exploration and production of unconventional gas resources are carefully considered. In particular, government policies should give adequate consideration to the concerns of local communities, but also focus on the key role natural gas plays in the Australian economy, both in terms of value creation and as an essential service.

Policy settings must also avoid duplicative and often inconsistent state and federal requirements. According to research conducted by the Australian Petroleum Production and Exploration Association, duplicative state and federal regulations may be holding back projects worth around $200 billion without any environmental benefit.[1] The Productivity Commission reiterated these concerns, highlighting the overlap and duplication of similar regulatory processes as "*one obvious source of unnecessary burden for proponents of major projects*".[2] Government initiatives to reduce green/red tape should therefore be supported, including the proposed one-stop-shop for environmental approvals.

[1] The Australian Petroleum Production and Exploration Association, *Cutting green tape: streamlining major oil and gas project environmental approvals processes in Australia*, February 2013.
[2] The Productivity Commission, *Major Project Development Assessment Processes – Research Report*, November 2013.

Improving administration/management of petroleum titles

The government previously outlined changes to the management of oil and gas retention leases with a view to delivering greater scrutiny of applications. These included:

- Verifying that companies seeking to retain a lease over oil or gas fields have a legitimate need to secure gas for long-lived production projects and are not simply seeking to obtain a competitive commercial advantage by their retention.

- Should a field become commercial, requiring the company holding the retention lease to apply immediately to the Minister for a production licence to bring the field online. Alternatively, at the end of the retention lease period, the lease should be offered on a tender basis for a production licence.

Arguably the most essential component of the retention lease system, limited transparency with respect to the way in which commerciality is assessed has raised some concerns about the appropriateness of retention lease policy arrangements more broadly. In particular, that a potentially narrow assessment of commerciality and lack of third party participation and transparency in the assessment process could potentially subdue obligations on producers to bring commercially viable gas resources to production. Given a reliance on high-cost offshore gas resources and limited diversity of domestic supply, this issue has particular relevance to Western Australia.

The former Commonwealth Government appeared to be cognisant of some of these issues, with the 2012 Energy White Paper outlining a number of key actions. These included updating the retention lease arrangements to: improve transparency; allow third party comment on the commerciality of developing particular fields; and specifically have greater regard to the potential for projects to supply the domestic gas market when considering granting a production licence.

The Association is supportive of ensuring these key actions are delivered in addition to exploring whether there are other appropriate avenues to promote use-it-or-lose-it contestability such as auctioning, as foreshadowed by the government.

III. Improve commercial and regulatory environment for infrastructure

Regulation of pipeline infrastructure

Transmission pipelines are highly capital intensive investments that require a substantial level of debt gearing. As such, long-term foundation contracts have generally been required to provide revenue certainty to underpin investment in a transmission pipeline project. While this may frustrate incremental demand growth to some degree over the short term, it does not appear to have been a fundamental constraint to the development of the industry. Significant investment in pipeline capacity has occurred, with the current framework providing a reasonable balance of end-user protection with service provider protection and incentives. These arrangements have also provided for a transmission network that is relatively free of constraints.

Long-term bilateral contracts are likely to remain a prominent feature of the market given the capital intensive nature of gas production/transportation and commercial and regulatory signals driving investment remain appropriate. But there are potential efficiencies in utilisation to be gained through mechanisms like capacity trading (addressed in more detail below). Further, persistent policy uncertainty in the exploration/production sector has the potential to impede the timeliness and efficiency of infrastructure investment and supply. As discussed, it is difficult for businesses to commit finances when the rules/regulations governing access to supply are in a constant state of flux.

With regard to the suitability of different carriage models for pipeline regulation, the study appropriately acknowledges there are strengths and weaknesses to both the market carriage and contract carriage models. Despite these differences, the current hybrid approach where different models apply to different assets appears to have met the particular demands of the market and it is not clear there is an immediate issue to be resolved.

To this end, the Association would question the rationale of imposing further reforms in this space. A more detailed and strategic assessment of perceived issues and the basis for reform in the context of the broader east coast gas market would be required before taking any such steps.

Improving price discovery and utilisation of infrastructure

The east coast gas market has not developed a liquid and flexible market for secondary trading of transmission capacity. The absence of such a market does not necessarily imply there is a market failure or that investment has been inefficient. A lack of secondary trading could be reflective of a number of factors, including the fact that gas pipeline capacity is not homogeneous, with different terms and conditions and operating environments applying to each.

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

Addressing this desire for more transparent and shorter-term price signals in an established but evolving market is not without its challenges. There are sovereign risks to be considered where the rights of existing capacity holders – established under pre-existing long-term contracts – are potentially compromised. This creates significant regulatory risk, the implications of which could impact upon future levels of investment. Further, it is not clear that implementing some form of mandatory trading would deliver the efficiency gains necessary to justify such significant intervention.

On this basis, the Association is not supportive of implementing reform options that would lead to mandatory trading of unused pipeline capacity. Rather, where regulatory intervention is to be considered, a light-handed and incremental approach that has appropriate regard for existing contracts is likely to be the most appropriate response. Efforts to improve information provision and potentially reduce transaction costs would appear to be a good starting place in this regard, as endorsed by SCER.

Such an approach provides a better balance of risks/benefits relative to some form of mandatory trading and would likely be consistent with supporting industry-led initiatives such as the ‘trade facilitator’ model currently under development.

The Association looks forwards to working through these issues with government. An important consideration in this regard will be to understand how reform options would interface with existing wholesale trading market platforms on the east coast.

IV. Market data and transparency

Improved market information on CSG delivery

Improving the market’s ability to form expectations about gas supply is in the interest of all market participants. To the extent there is additional information from upstream projects that could be voluntarily reported to the market, this may be useful. A key first step would be to determine the type of information that could be reasonably provided under current reporting arrangements. Careful consideration would obviously need to be given to the risks of revealing commercially sensitive information.

If mandatory data/information requirements are contemplated, the compliance costs associated with such provisions should be taken into account. While it would be difficult to conduct a cost-benefit analysis per se, any information requested would need to deliver value to the market more broadly.

It would also be unreasonable to impose requirements on CSG and LNG proponents and not the upstream sector more broadly. Improving market information about gas supply from CSG projects will not resolve market tightness in the near term and should not therefore, be used as justification by policy makers for imposing specific requirements on those businesses alone.

Priority areas for improving facilitated gas markets

From a competition perspective, the facilitated markets play an important role in enabling new entry to the gas market. They also assist market participants with managing their operational risks by establishing a market-based mechanism to manage daily imbalances between injections and withdrawals. But these benefits do not come cheap. The facilitated gas markets impose relatively high costs per GJ traded – a little under $1 per GJ for the Short Term Trading Market (STTM) and around 50c per GJ for the Declared Wholesale Gas Market (DWGM).[3,4]

The key factor driving these relatively high costs is the low volume of gas traded between participants on the facilitated markets – around 4 per cent of total withdrawals in the STTM and 6.9 per cent in the DWGM.[5] The facilitated markets are generally seen by participants as imposing financial risk and exposure. They are mandatory and where a participant takes a position that is not covered contractually,

[3] These cost estimates are only very broad estimates and do not take into account the avoided costs associated with the markets.
[4] Energy Supply Association of Australia, *Assessment of the east coast gas market and opportunities for long-term strategic reform*, May 2013.
[5] Ibid.

they become exposed to potentially high prices in the event of market disruptions. As a result, market participants generally seek to closely match their own injections and withdrawals to minimise exposure and manage their risk with longer-term bilateral contracts.

The limited size of the east coast gas market may provide a barrier to increasing trading and liquidity on the facilitated markets and long term agreements for gas supply and (outside the DWGM) transportation remain essential for establishing a sustainable position in the east coast gas market. But reducing risks of participation could support market development and potentially pave the way for the establishment of financial risk management products and ultimately a reliable price index. The ability to obtain a forward price for gas that is visible and tradeable is an important feature of liquid and transparent gas markets globally.

Steps to developing reforms to address this and support the development of more liquid and transparent wholesale markets include identifying:

- the key barriers to participants (or potential participants) taking up pure ‘buy’ or ‘sell positions in the market; and

- options for reducing or hedging the risks of participation in the market.

Given differences between the STTM and DWGM, consideration should also be given to identifying areas where consistency can be increased between the facilitated markets. This will assist in reducing net costs for market participants more broadly.

Role of industry-led initiatives

Industry-led initiatives – particularly in evolving markets – should be encouraged and supported. They generally emerge where there is need and have the potential to deliver important market benefits without any associated regulatory burden and the costs these entail. As acknowledged in the study, the industry-led ‘trade-facilitator’ model for secondary capacity trading currently under development is a positive initiative in this regard.

The characteristics of the east coast gas market (e.g. limited depth, geographically diverse, reliance on long-term bilateral contracts 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, governments have an important role to play in delivering a strategic but light-handed approach that addresses potential barriers to industry innovation and is conducive to market development.

V. Role for non-market interventions

Non-market interventions such as domestic reservation policy are not warranted. Building confidence in, and oversight of, the market is a more appropriate response to the challenge, particularly in the current environment where businesses across the supply chain are trying to adjust to changing market dynamics. Policy certainty with respect to upstream resource development and the creation of a broader gas market reform strategy to drive competition and efficiencies across the supply chain is needed.

VI. Governance and implementation issues

Given the cross jurisdictional nature of the interconnected east coast gas market, the Standing Council on Energy and Resources (SCER) is the appropriate body through which to oversee the implementation of existing commitments and any future gas market reform agenda, should one be required. Implicit in this approach is the need for continued stakeholder consultation. Further, more dynamic flow of information to Energy Ministers – particularly with respect to review outcomes – would also be beneficial, since decisions taken in one jurisdiction have the potential to impact the broader gas market.

While SCER is well placed to lead the reform agenda, it is not clear there is a need to heighten its role with respect to monitoring and supervising markets. In particular, the Association is unsure as to what gap SCER would be filling given the existing roles of the AER, AEMC and AEMO. To the extent there is any ambiguity over the roles and responsibilities of these market and regulatory bodies, the review of energy market bodies scheduled for mid-2014 could provide an opportunity to clarify roles and accountabilities.

In considering roles and accountabilities, the Association has some reservations over the statement "*there could also be merit in giving further consideration to AEMO taking on a broader gas market operator role*". It is not immediately evident what this would entail and the study provides no rationale or context for doing so. The esaa would caution against expanding the role of AEMO, particularly if it resulted in changes to existing market arrangements. It is important to explore and develop a forward reform agenda that considers opportunities for broader market development prior to considering additional market interventions.