29 March 2016

Mr John Pierce
Chair, Australian Energy Market Commission
Level 6, 201 Elizabeth Street
Sydney NSW 2000

Submitted online via the AEMC website

Dear Mr Pierce

RE: Discussion Paper- Review of the Victorian Declared Wholesale Gas Market (GPR0002)

ERM Power Limited (ERM Power) appreciates the opportunity to provide comments to the Australian Energy Market Commission (AEMC) on the Discussion Paper issued in relation to the Victorian Declared Wholesale Gas Market (DWGM) Review.

About ERM Power

ERM Power is an Australian energy company that operates electricity generation and electricity sales businesses. Trading as ERM Business Energy and founded in 1980, we have grown to become the 4th largest electricity retailer in Australia, with operations in every state and the Australian Capital Territory. We are also licensed to sell electricity in several markets in the United States. In addition, in 2015 we commenced gas retailing to industrial and commercial customers in Victoria. We have equity interests in 497 megawatts of low emission, gas-fired peaking power stations in Western Australia and Queensland, both of which we operate.

ERM Power is a gas retailer in the DWGM of Victoria, a shipper in the Brisbane Short Term Trading Market and a trading participant at the Wallumbilla Gas Supply Hub.

Comments on the DWGM discussion paper

ERM Power welcomes the AEMC's review of the east coast gas markets and the opportunity to provide our input. In our submission dated 12 February 2016 to the AEMC's Draft Report on the Review of the Victorian DWGM (DWGM Draft Report) and Stage 2 Draft Report on the East Coast Wholesale Gas Market and Pipeline Frameworks Review, we outlined our support for the majority of the proposals to enhance gas market transparency and some of the recommendations designed to enhance access to pipeline capacity. In respect of the DWGM, we appreciate the objectives that the AEMC is trying to achieve by its proposals. However we have significant concerns that the AEMC's proposals have been underpinned by unsubstantiated assumptions about the likely level of liquidity, and that there is a high risk that the proposed changes will create barriers to entry, stifle retail gas competition and lead to increased costs for gas consumers.

ERM Power is also concerned that the AEMC appears to have prematurely determined its preferred approach (as first set out in the DWGM Draft Report released in December 2015) and is pursuing its proposed design without taking into account industry feedback. We note that only about three weeks after submissions were due on the DWGM Draft Report in mid-February 2016, the AEMC released its 75 page DWGM Discussion Paper. This Discussion Paper simply builds on the proposed model set out in the DWGM Draft Report, completely disregarding stakeholder concerns raised in submissions.

We refer the AEMC to our previous submission in which we outlined our concerns in detail. We highlight some of our main concerns in this submission.

1. The case for overhauling the current arrangements has not been substantiated by any cost benefit analysis

The existing DWGM arrangements have been recognised as being successful at providing an effective and competitive gas balancing service and facilitating trading of gas in Victoria, and promoting retail competition.[1] The demonstrated effectiveness of the existing DWGM arrangements suggests that there is a role for the current arrangements in promoting both the COAG Energy Council's vision for the future gas market, and the National Gas Objective.[2] While we consider that there are certainly a few aspects of the current arrangements that could be improved, in general we believe that the market has been functioning well and therefore any proposal that involves discarding the existing arrangements and replacing it with an entirely new model must be supported by a comprehensive and transparent cost benefit analysis with input assumptions validated. There should also be an assessment against an alternative scenario. To date we have not seen any cost benefit analysis or any assessment of the proposed model against an alternative.

ERM Power disagrees that the proposed model will result in the range of benefits purported by the AEMC, such as emergence of financial products, increased options to hedge price risk, and reduced barriers to entry.[3] The benefits put forward by the AEMC are underpinned by an assumption that the voluntary trading market will be, or will become, deep and liquid, however this assumption is not substantiated. This point is further addressed in the discussion below.

2. Removal of the mandatory gross pool arrangements will increase barriers to entry and reduce transparency

The current DWGM arrangements provide a genuine and low transaction cost alternative to bilateral contracts for sourcing supply. The current arrangements produce a market price that is transparently determined and reasonably reflective of underlying demand/supply conditions. These features are highly valuable to new entrants who may find it difficult to secure small volumes on competitive terms (particularly when they are just starting operation), and who are able to use the market price as a basis for evaluating the reasonableness of supply offers. Large users have also reported that they find the mandatory facilitated trading markets to be useful in helping them to manage their gas supply

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[1] AEMC, Draft Report, Review of the Victorian Declared Wholesale Gas Market, 4/12/15, pg. 1.

[2] The National Gas Objective as set out in Part 3 of the National Gas Law is to *"promote efficient investment in, and efficient operation and use of natural gas services for the long term interest of consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas".* The COAG Energy Council vision is available at http://www.scer.gov.au/publications/coag-energy-council-australian-gas-market-vision.

[3] For example, in its Victorian DWGM Review Information sheet (paragraph 3 & 5 on page 2), the AEMC makes several assumptions about the benefits that the reforms will bring, for example,

- *"the proposed reforms will not undermine elements of the Victorian market that have been beneficial both in terms of stimulating a competitive retail gas market and safeguarding the security of supply for Victorian customer.",*
- *"the recommended new market design would provide more options to new entrants to hedge price risks through either physical or financial trades at the virtual hub",*
- *"This optionality lowers barriers to entry and promotes competition, creating benefits for consumers."*

As discussed in our submission, these claims have not been substantiated.

requirements.[4] The unwinding of the current DWGM arrangements and its replacement with a voluntary trading exchange will extinguish these benefits and increase barriers to entry. The risk of low liquidity in a voluntary exchange is an issue that has been raised by others such as AEMO, APA and AGL, with APA and AEMO both noting the consequential adverse impact on new entrants/small participants.[5]

Removal of the mandatory gross pool will also eliminate transparency of price and key market information pertaining to gas supply sources and costs that can currently be deduced from analysis of bid stack data.

3. Significant risk that liquidity in a voluntary market will be low

The AEMC should clarify why it believes a voluntary exchange will give rise to a liquid trading market, and provide evidence or a rationale. In our view there are factors that suggest that there is a high risk that liquidity in a voluntary trading market implemented in Victoria will be low.

The AEMC has formed its proposals on the basis of there being over 50 market participants in the DWGM. This figure was referenced in the Stage 2 Draft Report (East Coast Wholesale Gas Market and Pipeline Frameworks Review), the Wholesale Gas Markets Discussion Paper, as well as the Stage 1 Report (East Coast Wholesale Gas Market and Pipeline Frameworks Review), Appendix F.[6] However, this figure is incorrect. Based on our calculations using data from AEMO, there are only 18 entities that are registered to trade as market participants in the DWGM.[7] The AEMC's significantly inflated DWGM market participation count raises questions about the validity of the input assumptions that underpin the AEMC's proposed model and its claimed benefits.

The AEMC's proposed model is unlikely to lead to increased trading or liquidity given that it does not increase the level of competition in the upstream production sector, nor does it enhance gas supply availability, nor does it increase incentives to producers to sell gas through the spot market. The proposed system of entry capacity rights may in fact discourage participation by producers who may

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[4] Refer to submissions lodged throughout the review by Visy Paper, Qenos, Australian Paper and SA Water Corporation, and Adelaide Brighton Cement, which all discussed the value of retaining a mandatory gross pool. Some explicitly expressed concerns with unwinding the mandatory markets. For example, Qenos in its submission to the Wholesale Gas Markets Discussion paper stated, *"The experience in the current STTM's and Wallumbilla Gas Supply Hub has shown that compulsory participation by both suppliers and end users is required to maximize market depth and liquidity"* (pg 1). Adelaide Brighton Cement in its submission to the Stage 2 Draft Report noted, "*the proposed Southern Hub design is premised on a voluntary exchange based trading model. We do not believe a voluntary hub can achieve a liquid and transparent market*" (pg 5). Australian Paper in its submission to the Stage 1 Report stated that a voluntary market would "*further the interests of gas producers by removing a competitive alternative supply option and push consumers back to more traditional gas contracting options*" (pg 3).

[5] AEMO submission to the Victorian DWGM Draft report, 12/02/16, discussion in section 1.1, AGL response to East Coast Gas Review and DWGM Draft Reports, 15.02.06, page 2, APA Group submission to DWGM Draft Report, discussion in section 5.4 & 5.5.

[6] In the AEMC's Stage 2 Draft Report, the AEMC states "*it was estimated that there were over 50 market participants in the DWGM*" (pg. 25). In its Wholesale Gas Markets Discussion Paper, the AEMC refers to 52 participants in the DWGM (pg.17). In the Stage 1 Final Report, the AEMC provides the basis for its calculation in Appendix F (pg.272), in the table marked "DWGM Market Participants", however this table erroneously includes a range of participants who are not registered to participate in the DWGM (e.g. Stanwell, Incitec Pivot, QER and others).

[7] Based on AEMO report INT 125. Included in our count are those registered as a market participant retailer, trader or distribution/transmission customer, with a participant that owns multiple registered entities being counted as a single entity.

find it costly to purchase capacity rights for a fixed period to support an occasional trade and/or a burden to manage short term trading of those entry rights.[8]

Liquidity in the voluntary exchange may also be limited because market participants have other options outside the exchange, such as the ability to store gas (and use it at a later time, or sell it at a later time when a larger profit can be made) or undertake bilateral trades outside the exchange (which may be preferred to keep the trade undisclosed to the rest of the market). We also note that two of the largest gas retailers in Victoria have relationships with LNG producers (Origin's relationship with APLNG and AGL being a supplier to GLNG) and are likely to have incentives to utilise any spare gas for LNG.

The Wallumbilla Gas Supply Hub (GSH) is an example of a voluntary market where liquidity is relatively low. The GSH has been operating for more than 2 years, comprises 17 trading participants (similar to the DWGM) including the LNG participants, the largest shippers in the east coast gas market, but has averaged only 2 trades per day since market start. On some days, there are no trades at all.[9] In our view the low number of trades is a result of divergence between bid and offer prices (rather than the separation of trading locations).[10] We also observe that there have been no trades of the Wallumbilla financial derivative listed by the ASX. In addition, despite Queensland having many large gas industrial users, there are only two who trade on GSH (excluding power generation), most likely because industrial users are not equipped with resources dedicated to a trading function.

We are not suggesting that these outcomes are indicative of flaws in the GSH design, rather, we are emphasizing that the industry structure and relatively small number of participants, as well as the options available to participants outside a voluntary market, will impact on liquidity in a voluntary market.

Some have argued that a trading exchange model such as the GSH would attract more participation by retailers or large gas users if it provided a balancing mechanism to alleviate non-delivery risk (such as that proposed by the AEMC in respect of the DWGM). However we would argue that the balancing arrangements proposed by the AEMC in respect of Victoria, will simply exacerbate barriers to entry, given the expected volatility of offer pricing in an illiquid market and the risk of exposure to significant balancing costs.[11]

Unlike Wallumbilla, the DWGM is a market which primarily serves gas consumers at a demand centre. In the DWGM context, it is therefore critical to ensure that the market design does not impede the growth of retail competition by prohibiting the entry of new players. This is crucial to achieving the National Gas Objective which focuses on the long term interests of gas consumers.[12] The AEMC's proposal to remove the current DWGM gross pool arrangements, which have been successful at facilitating retail market entry, appears to have disregarded the impact on competition in the Victorian retail gas market and the longer term impact on gas consumers.

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[8] Under the current arrangements, a participant only needs to secure accreditation at the particular injection or withdrawal point to sell or buy in the wholesale market.

[9] Based on GSH Daily Transaction Summary Report data published by AEMO. Average is calculated over all days in the period from 20/03/14 to 10/03/16 including all product types and pipelines.

[10] ERM Power has observed that often the same bid/offer spread tends to appear on both the SWQP and RBP locations; i.e. even if the bids and offers were amalgamated at a single location, the spread in bid/offer prices would not be reduced.

[11] Under the AEMC's proposed model, a participant who is unable to rectify a short position due to lack of access to contracted flexible gas supplies, would face the risk of having to purchase high priced gas from the exchange, or fund the cost of high priced gas purchased by the hub operator from the exchange.

[12] Refer to footnote 2 for the National Gas Objective.

4. The proposed system of entry/exit capacity rights imposes barriers to short term interregional trading

The proposed arrangements do not enhance the ability of shippers to flow gas from one location to another. The ability to flow gas from one location to another is determined by access to pipeline capacity, not the trading arrangements within the DWGM. In fact, the proposed system of entry/exit capacity rights is likely to make it harder for participants (other than the incumbent shippers on the interconnecting pipelines) to take advantage of any short term inter-regional trading opportunities, compromising the effectiveness of the AEMC's suite of proposals to enhance access to pipeline capacity.

5. The balancing regime imposes risks on small participants who lack access to flexible gas supplies

The balancing regime is likely to impose disproportionate risks on small retailers and new entrants, who are unlikely to have access to flexible gas supplies (that can be nominated and injected on the gas day or at short notice), that could be used for their own balancing requirements or to sell to the market as balancing gas. There are also gaming risks that we outlined in our earlier submission.

6. Increased resource requirements will disadvantage small participants and industrial users

Continuous trading under the AEMC's proposed model (which participants will be required to do in order to minimise exposure to unpredictable and potentially significant balancing costs) will increase resource requirements, which can be onerous for both small participants and large users. Such participants are likely to lack trading teams who can be dedicated to monitoring the real time balancing position and engaging in trading on the exchange throughout the entire day. Such resourcing requirements may discourage participation in the market by small players or industrial gas users.

In conclusion, ERM Power is concerned that the AEMC's significant changes proposed to the Victorian DWGM are unlikely to bring about a liquid and transparent market, will deter new entrants, particularly new entrant retailers, and will be extremely costly to design and implement. The changes proposed are likely to lead to increased costs on gas consumers in the longer term, an outcome inconsistent with the National Gas Objective. ERM Power refers the AEMC to our previous submissions for the full set of issues we have raised with respect to the AEMC's proposed changes to the DWGM. We strongly recommend that the AEMC reconsiders its approach, and considers developing more incremental and targeted improvements that build on the proven strengths of the existing DWGM arrangements, to achieve the National Gas Objective and COAG Energy Council vision.

Please feel free to contact me if you would like to discuss our submission.

Regards

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