



**Submission to
the Ministerial Council on Energy**

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**APIA Response to the Allen Consulting
paper on Wholesale Gas Market**

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Executive Summary

The Ministerial Council on Energy commissioned the Allens Consulting Group to prepare a report on options for wholesale gas market developments. Allens recently released its Final Report 'Options for the development of the Australian wholesale market' which proposes options for government intervention in the wholesale gas market.

The Australian Pipeline Industry Association (APIA) is strongly of the opinion that issues concerning the process of developing the Final Report and the report itself need to be addressed.

The case for regulatory intervention has not been made

APIA is concerned that Allens were not asked to assess whether any intervention in wholesale gas market was needed in order to assist in the development of the gas market. The terms of reference for Allens' work were based on the assumption that intervention was necessary, and they should report on the most appropriate form of intervention.

The wholesale gas market is continuing to develop. Imposing sophisticated mechanisms at this stage of the market's development would not accelerate that development. Instead it is likely to simply increase the costs of doing business and hinder continued development.

As the wholesale gas market grows, it will develop its own more sophisticated trading mechanisms. In fact, the majority of submissions to the Allens Draft report argue that the market is working reasonably well at present and will develop naturally over time. The fact is that it is in all participants' interests to support the development of more liquid and transparent market where possible. This is already occurring with initial activity such as moves to develop industry Codes of Conduct, attempts to establish trading websites incorporating information on available capacity and publication of access principles for unregulated pipelines, and standard form gas trading contracts.

Concerns with proposed options

The options outlined in the Final Report focus on establishing mechanisms such as bulletin board facilities and city gate schemes as a means to improve liquidity in the market and accelerate the development of the market.

There needs to be significant increase in demand in order to justify the costs associated with creation of more sophisticated trading regimes. For example, spot prices work effectively when there is a multiplicity of buyers and sellers. These conditions are not present yet. Such mechanisms may not be needed, and do not work as well, especially where mandated by governments acting from outside the market and forced upon market participants, rather than developed within markets through participant cooperation. For a significant number of pipelines, these arrangements may be unnecessary simply because there may only be one existing customer on a particular pipeline.

Submissions from the gas industry to the Allens Draft Report revealed substantial problems with the options proposed. The Allens Final Report did not quote or respond to these problems.

Conclusion

APIA is concerned that the Final Report sets the wrong direction for reform. Governments need to consider whether there is a need for regulatory intervention before considering the form of that intervention. The risk is seeking to adopt the Allens Final Report is that a costly and bureaucratic process will be imposed from outside on the gas industry, simply resulting in a higher price for gas at the cost of all gas market participants.

Australian Pipeline Industry Association submission to the Allens Consulting Group 'Options for the development of the Australian wholesale market – Final Report'

Background

In its 2002 Report, the Council of Australian Government's Energy Market Review (CoAG Review) found there was merit in looking at ways to develop the gas commodity market.

The Ministerial Council on Energy (MCE) released its Statement on Principles for Gas Market Development in December 2004. The MCE also commissioned the Allens Consulting Group to prepare a report proposing options to accelerate the development of a reliable, competitive and secure wholesale natural market consistent with these principles.

The Allens Consulting Group released its Final Report 'Options for the development of the Australian wholesale market' (Final Report) in June 2005 proposing four options for government intervention in the wholesale gas market. Option 1 is the 'base case' involving continuation of the existing market. Option 2 involves mandated bulleting 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 VENCORP model nationwide.

Introduction

The Australian Pipeline Industry Association (APIA) has concerns that the process that led to the development of the Final Report failed to assess whether any intervention in wholesale gas market was needed in order to achieve the MCE's policy goals. The Final Report did not consider the case for regulatory intervention. Instead, the Final Report identified and evaluated options for intervention.

Good regulatory practice demands a cautious approach to intervening in markets and recognises that intervention carries costs that may outweigh benefits or reduce entrepreneurial initiatives.

APIA is concerned that the Final Report sets the wrong direction for reform and potentially could hamper the natural development of the market. Of particular concern is that the extensive submissions made by industry on the Draft Report do not appear to have been taken into account. Submissions revealed substantial opposition to the options proposed (excluding the base case presented in option 1) and highlighted difficulties associated with their implementation. The Final Report only cursorily addressed these issues.

APIA submits that prior to Government developing, or directing industry to develop, a model for wholesale gas market reform, the case for regulatory intervention should be assessed. To date no robust assessment has been undertaken on whether regulatory intervention in the wholesale market is beneficial.

Making the case for further regulatory intervention

Good regulatory practice requires that any regulation should not only serve clearly identified policy goals, but the regulation must be effective in achieving those goals. The OECD Guiding Principles for Regulatory Quality and Performance 2005 states:

Good regulation should: (i) serve clearly identified policy goals, and be effective in achieving those goals; (ii) have a sound legal and empirical basis; (iii) produce benefits that justify costs, considering the distribution of effects across society and taking economic, environmental and social effects into account; (iv) minimise costs and market distortions; (v) promote innovation through market incentives and goal-based approaches; (vi) be clear, simple, and practical for users; (vii) be consistent with other regulations and policies; and (viii) be compatible as far as possible with competition, trade and investment-facilitating principles at domestic and international levels.¹

While the policy goals for gas market development have been identified by the MCE, no robust assessment has been undertaken on whether further regulatory intervention is necessary to achieve them.

The Final Report identified the key question for the next phase of gas market reform as – What is the role of Government in wholesale gas market development going forward? The Final Report does not provide an answer to this fundamental question and appears to query, at least in part, the need for intervention:

No option has been developed as a preferred or optimal option on its own. The options are vehicles for discussing concepts and development opportunities. They expose the major issues relevant to the Australian wholesale gas market to inform the overall debate on what development intervention, if any, should take place next².

The Australian wholesale gas market has developed rapidly over the last ten years and there is no reason to assume that this development will not continue. The Final Report, itself, provides no justification for regulatory intervention in the normal development of the market. There is also little or no analysis of how any proposed intervention could disrupt current market arrangements at the cost of participants.

The case for regulatory intervention has not been made. APIA submits that in the absence of a clear justification for regulation, it is premature to consider options for intervention.

No case for regulatory intervention

APIA queries whether there is a case for further regulatory intervention in wholesale gas market development. The gas market, while evolving, remains relatively immature. It would be naïve to consider that simply imposing sophisticated mechanisms would make the market mature like in the United States or United Kingdom. The market is likely to develop more sophisticated trading mechanisms over time as the demand for such mechanisms grows and the benefits outweigh the

¹ OECD, *OECD Guiding Principles for Regulatory Quality and Performance*, 2005, p3.

² The Allen Consulting Group, *Options for the development of the Australian wholesale gas market – Final Report*, 2005, p 38.

costs. The risk of intervening prematurely is that such mechanisms may be closed off, their effectiveness distorted, or that the wrong mechanisms are chosen.

Measures directed towards creating a central co-ordination role are particularly questionable given the Australia gas market is characterised by concentrated upstream production and consumption and has a history of bilateral long-term contracting. These characteristics and structure are a consequence of the substantial capital and inherent risks associated with gas exploration, production and infrastructure investment.

APIA also firmly believes that adherence to the gas market principles espoused by the MCE, at least with respect to the pipeline industry, is already high.

Information on market and system operations and capabilities at all stages of the gas supply chain should be publicly available and frequently updated:

Major pipeline costs, price and capacity are all public via the regulatory process. 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 information on the terms and conditions of access and provide 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. (Refer page 6 of this submission).

Gas market structure to facilitate a competitive market in all sectors:

The CoAG Review found that further market development could be achieved by increasing competition in upstream markets. The Code, by regulating access to gas transmission pipelines, ensures that competition is possible in both upstream and downstream markets.

Increased investment in transmission pipelines will generate further competition in the upstream and downstream markets. Further costly and unjustified regulation in the pipeline sector will not result in increased and efficient investment in pipelines.

Market participants should be able to freely trade between pipelines, regions and basins:

Measures that encourage pipeline development will also support the ability for market participants to trade between regions and basins. The Final Report states:

The current market structure is encouraging an amount of new investment in new interconnectors, which, in turn is making trade between pipelines, regions and basins more free³.

There should be regulatory certainty and consistency across all jurisdictions:

Regulatory certainty is a key factor in decisions to invest in major infrastructure and without regulatory certainty there is unlikely to be major investment.

³ The Allen Consulting Group, *Options for the development of the Australian wholesale gas market – Final Report*, 2005, p 54.

Intervention in the market without robust analysis and justification will not provide any certainty or comfort to investors in transmission pipelines. The market systems presently available reflect the level of maturity of the wholesale gas market in Australia. There is no reason to assume that the gas market will not continue to grow and as the market develops, more sophisticated systems will evolve in response to market needs. No barriers to market development have been identified.

Market design and institutional requirements responsive to and reflective of the needs of the market and market participants:

The MCE in its Statement of Principles notes that Governments may have a role in facilitating the process of market development and ensuring all stakeholders interests are appropriately represented or considered and balanced. The case for Government involvement has not yet been made.

APIA considers that organic development of the market and trading mechanisms is likely to be superior to and more market-oriented than government-imposed 'market development'. Mandated solutions imposed on industry by government are unlikely to be supported by industry to the extent that market driven and industry developed solutions would be.

The case for the proposed options

Option 1

Option 1 involves continuation of the existing market arrangements and natural evolution to more sophisticated trading arrangements. APIA supports option 1.

There was also substantial support for option 1 in the submissions to the Draft Report from a broad cross-section of the gas industry. A common theme in submissions was given the characteristics of the Australian gas wholesale market, organic development is likely to produce the best and most efficient results for future wholesale gas market development.

Organic growth is most suited to the current state of the market. While this will change over time, it would not be appropriate at this time for government to intervene. (APPEA)

The Australian gas market is becoming increasingly dynamic. As the liquidity of the market increased, the further development of the existing wholesale gas markets will occur as market participants identify viable opportunities. ... However, for government to intervene and mandate any of these options, in the absence of market failure and under non-emergency conditions, would impose a costly and inefficient industry structure that would be paid for by end users. (esaa)

The gas industry has evolved significantly, with particularly rapid change over the last five years. ... Australia's gas supply arrangements continue to deliver reliable and efficient results; there is not a case of market failure that would warrant government intervention to impose some alternative market structure. AGL believes that inappropriate intervention may in fact result in less efficient outcomes. (AGL)

the wholesale gas market will develop most effectively by promotion of greater participation in a free and even market without unnecessary regulatory intervention. (ExxonMobil)

Option 1 takes account of the fact that the gas market in Australia is currently relatively immature but is evolving and becoming increasingly competitive. It is a realistic approach to gas market development allowing the market to evolve to more sophisticated trading arrangements when the market values them.

Examples were also provided in the submissions which demonstrated the benefits of allowing an industry to evolve and respond to market forces. The development of water markets in Australia illustrates that markets can evolve successfully through internally driven initiatives without the need for regulatory intervention. Following its formal inception in the 1980s, water trading largely occurred via transactions between individual parties or through brokers and agents, and without a formal entitlement exchange arrangements. In the later 1990s on-line water markets such as watermove.com.au and waterexchange.com.au were established by market participants and are developing as a natural competitive response.

There have already been developments in the gas transmission sector. Through the Australian Pipeline Industry Association (APIA), the sector committed to the development of an industry Code of Conduct which includes a commitment to provide relevant information 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). The website includes information on currently available firm and as-available capacity together with a page dedicated to hosting available spare capacity offers from existing users. Similarly, Enertrade makes publicly available access principles for its Moranbah to Townsville pipeline which ensure potential customers have comprehensive product information as well as provide for non-discriminatory access.

It is in all participants' interests to support the development of more liquid, transparent markets. Producers benefit as new markets open up in which to market and sell their product. Pipelines benefit because customers are more likely to commit to capacity when there is an active and liquid secondary market underpinning both greater volumes on existing pipes and new pipe developments. Users benefit from the diversity of services and prices in an active and competitive market.

Despite significant support for option 1 from a broad cross-section of industry participants and evidence of the market growing and evolving, the Final Report appears to dismiss this option on the basis that it will not meet the 'timetable' for development to occur in the short to medium term⁴.

Option 2 & 3

Options 2 and 3 in the Final Report focus largely on transparency as a means to improve liquidity in the market and accelerate the development of a reliable, competitive and secure wholesale natural gas market.

APIA agrees that transparency plays an important role in the efficient functioning of a market but considers that there are a number of difficulties with the approach taken in the Final Report.

⁴ The Allen Consulting Group, *Options for the development of the Australian wholesale gas market – Final Report*, 2005, p 53.

In respect of the pipeline sector, there is currently a high level of transparency by virtue of the provisions of the Code and because it is in the commercial interests of pipelines to provide information about spare capacity to the market. APIA believes there are likely to be diminishing returns, if any, from further information disclosure. In this context, there is a need to balance the costs of increasing the regulatory burden against the benefits.

In the Final Report no assessment was made of the effectiveness of mandating that all pipelines comply with the non-price obligations of the Code in achieving the MCE's stated policy goals. Further, no assessment was undertaken on whether imposing these additional and considerable costs would result in a tangible benefit.

For example, some pipelines only serve one or two customers and are unlikely to serve many customers for the foreseeable future. Imposing bulletin board requirements, capacity trading arrangements, and mandatory posting of trades will do nothing to develop the sections of the market served by these pipes. There are numerous examples of such pipelines, in particular laterals off major pipes and a number of pipelines sized to cater for specific customers.

Submissions to the Draft Report directly challenged the usefulness of establishing a bulletin board facility. In particular, the diversity of user needs will render the trades posted on these boards irrelevant for other participants. It was argued that there needs to be significant underlying demand in order to justify the creation of sophisticated trading regimes.

... even if all market participants used the bulleting board for most of their trades it would still only reflect the liquidity of the underlying market which is currently relatively low in Australia. The existence of a market bulletin board will not necessarily create greater market liquidity, regardless of whether it is mandated or not. (Origin)

While it could be argued that certain types of bulletin boards could be established at a relatively low cost, such as those which simply stated spare capacity on an irregular basis, it is questionable what benefit it would deliver. Bulletin boards with significant dynamic features, however, can be highly costly. Examples were provided where bulletin boards had been established by pipeline owners but were subsequently abandoned because the relatively high costs of providing the service could not be justified given insufficient demand.

It was also argued in submissions that spot prices work effectively when there is a multiplicity of buyers and sellers, and a homogeneous product. They may not be needed, and do not work as well, in shallow markets like natural gas with few buyers and sellers, and varying service requirements among participants.

The market development options put forward by ACG are essentially for development of secondary "spot" markets. ... it is highly unlikely that any of the options will lead to significant changes in levels of wholesale market competition, liquidity or price reductions. (EUAA)

The Final Report also acknowledged:

There is no guarantee that a city gate scheme will increase liquidity in the contract market. A spot price is already determined in Victoria and there is no evidence of liquid contract trading based on this price. ... It is possible that a

*transparent spot price will encourage further trading, but the Victorian experience to date would suggest otherwise*⁵.

The Final Report also provides no quantitative analysis supporting the proposed market reforms. The only quantitative support for the proposed market reforms provided in the paper is a benefit of \$20 - \$30 million calculated by using an estimate of benefits as 1% of the value of gas used in Australia⁶.

Focus of options

The CoAG Review found that there was scope for further market development by increasing competition in upstream markets and made recommendations regarding separate marketing and acreage management issues. None of the options proposed directly target upstream competition. The Final Report appears to acknowledge this may potentially impact upon the effectiveness of the proposed options:

*wholesale markets have a high level of concentration in production, which could deprive any potential spot and forward contract markets of depth and liquidity on the supply side. ... Any steps to prompt or mandate more transparent wholesale transactions must be cognisant of this concentration, and the reality that it is likely to persist in the short to medium term*⁷.

The EUAA were also of the view:

the major barrier to development of a more liquid gas market is upstream concentrations, which may only reduce gradually over time without further policy actions, which justifies the MCE focusing particular attention on the areas of joint marketing, exploration leases and access to production facilities.

APIA submits that development of the Australian wholesale gas market is best supported by focusing on continued investment in the gas industry. In particular, continued investment in transmission will facilitate competition both in the upstream and downstream markets and in the transmission sector itself.

The key to driving gas market development and increasing the overall liquidity of the market is new investment. The Productivity Commission recognised this in their Review of the Gas Access Regime and noted the "potential for relatively small investments in interconnecting pipelines to increase the level of competition and to change how gas moves between sources of supply and end use markets". (esaa)

Conclusion

APIA submits that there strong arguments why further regulatory intervention to force gas market development, particularly in respect to transmission pipeline interventions, is not justified and unlikely to be effective to achieve the MCE's policy goals.

⁵ The Allen Consulting Group, *Options for the development of the Australian wholesale gas market – Final Report*, 2005, p 60.

⁶ The Allen Consulting Group, *Options for the development of the Australian wholesale gas market – Final Report*, 2005, p 68.

⁷ *Ibid*, p 22.

APIA is confident that the wholesale gas market will develop over time. Some participants have tried measures such as bulletin boards but there has been little or no interest. It is expected that interest and demand will grow as the market matures and the number of industry participants grow. It is this deepening of the market which will lead to the development of more sophisticated information platforms and trading arrangements.

As a matter of good regulatory practice, prior to developing options for intervention, it is critical that a thorough assessment is undertaken to determine whether further intervention is necessary and will be effective in achieving the MCE's policy goals. Failure to do so risks imposing costly and ineffective regulation on industry which will hamper rather than accelerate gas market development.