

2 May 2018

Gas Market Reform Group
c/o Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

By email: enquiries@gmrg.coagenergycouncil.gov.au

ECA SUBMISSION: CAPACITY TRADING REFORM PACKAGE

Energy Consumers Australia (ECA) is the national voice for residential and small business energy consumers. Established by the Council of Australian Governments (COAG) in 2015, our objective is to promote the long-term interests of consumers with respect to price, quality, reliability, safety and security of supply.

ECA welcomes the opportunity to provide this submission to the Gas Market Reform Group (GMRG) regarding the Capacity Trading Reform Package (Reform Package). The COAG Energy Council has already approved certain design elements of the gas capacity trading mechanism, which are reflected in the Reform Package.

Accordingly, the submission primarily focuses on aspects of the Reform Package in respect of which the GMRG has specifically sought feedback. ECA's submission is supplemented by a legal analysis by Maddocks Lawyers of relevant legislative and regulatory provisions contained in the Reform Package.

These are critical reforms that should be implemented in a timely and transparent manner faithful to the COAG Energy Council's intention to secure a step-change in the levels of transparency and competition in gas wholesale markets in the long-term interests of consumers. The GMRG, the Australian Energy Regulator (AER), the Australian Energy Market Commission (AEMC) and the Australian Competition and Consumer Commission (ACCC) should continue to closely monitor and report on the effect of the reforms to ensure that the reforms lead to a decrease in the price of gas delivered to consumers and end-users and that, if so, both this outcome and the effect of the reforms in achieving it are clearly communicated to consumers and large end-users.

A review of the impact and effectiveness of the Reform Package and broader gas market reforms in achieving the National Gas Objective and, particularly, serving the long-term interests of consumers following implementation, should be hard-wired into the regulatory framework. This review should be based on accurate information that can form a sound and reasonable basis for conclusions and recommendations regarding any amendments that might be needed to the new gas market arrangements.

1. ECA consultation with consumer advocates and large energy users

At the request of the GMRG, ECA convened a forum for interested consumer advocates and representatives of energy users to share user and consumer perspectives and insights regarding the Reform Package. While this submission is made exclusively by ECA, the forum discussion has helped to inform and shape the submission.



2. Overview of ECA's submission

ECA firmly believes that the long-term interests of consumers are best served through arrangements which promote effective competition, including by rectifying information asymmetry. Therefore, ECA strongly supports the various reforms that have been undertaken or are underway to deal with gas supply, access to gas pipelines and gas market transparency, including the gas capacity trading reforms, which are the focus of the Reform Package.

Nevertheless, ECA has identified the following ways in which the Reform Package could be enhanced to better serve the long-term interests of consumers, particularly in relation to ensuring energy affordability:

- *Limitations on scope of coverage:* Limitations on the scope of coverage of gas market reforms, particularly through exemptions, could compromise their ability to further the National Gas Objective and effect beneficial change in the long-term interests of consumers. The possibility of exploitation of exemption criteria should be explicitly considered and tested by the GMRG. The reforms also need to embed an ongoing monitoring role by the AER to ensure that exemptions continue to be justified after being granted.
- *Driving effective competition and curbing market power:* The Reform Package is designed to drive effective competition in the secondary capacity market and to impose constraints on the exercise of market power by pipeline operators. However, the way in which certain proposed reforms are interpreted and practically applied could limit achievement of these objectives – particularly provisions dealing with determination of zones, the content of standard operational agreements, amendment of facility agreements, auction market conduct rules and participation in secondary markets. Suggestions have been made in the submission as to how unintended outcomes could be avoided in relation to each of these issues.
- *Governance arrangements for the OTS Code:* The power of the AER to approve, reject and remit proposed changes to the Operational Transportation Service Code (OTS) and to change the Code on its own initiative will help to redress power imbalances that may be embedded in the composition of the OTS Code Panel. However, the AER's compliance and enforcement activity in relation to non-compliance with the Code and actions and instruments made pursuant to the Code (such as the standard operational agreements) could be significantly compromised as a consequence. Consideration should be given as to how the integrity and credibility of AER's compliance and enforcement role in this context could be preserved, notwithstanding its involvement in the development of and changes to the Code.
- *Transparency:* The requirement that participants in the capacity trading market report information to the Australian Energy Market Operator (AEMO) for publication will help enhance market transparency. However, transparency on its own will not deliver benefits for consumers unless the information generated by these reporting obligations is accessible and digestible and the integrity of the information can be assured. The AER's role in proactively monitoring and ensuring compliance with these reporting obligations on an ongoing basis will play a critical role in achieving these outcomes. The AER should be properly resourced to ensure that ongoing monitoring is effective in detecting and deterring non-compliance.
- *Cost recovery by transportation service providers:* The AER's review of a transportation service provider's charges is only triggered if the AER has concerns about their level or if concerns are raised by an interested party. Despite the costs associated with an *ex ante*



review of charges by the AER, the GMRG should consider whether the benefits would outweigh the costs, particularly from consumers' perspective. Moreover, the basis for recovery of costs associated with compliance with the regulatory framework by service providers should be based on outcomes, rather than inputs. This will help to avoid 'gold plating' and over-charging, which will ultimately have a detrimental impact on consumers.

3. Urgent need for gas market reform

There is clear evidence of the need for urgent gas market reform, particularly from the perspective of consumers. Specifically:

- Various factors have resulted in the reduction in the availability and diversity of gas supply.¹
- Most gas sales in eastern Australia occur under long-term bilateral contracts, which are confidential and, thus, opaque to industry and the public.²
- There is also a disparity between the type of information available to large participants such as gas producers and retailers and customers that participate less frequently in the market.³
- The substantial increase in demand driven by LNG exports has put upward pressure on domestic gas prices.⁴ With the recent expiration of many long-term gas supply contracts, domestic users have had to negotiate new supply contracts.⁵ Gas prices under these new supply contracts – which set the underlying price of wholesale gas – have risen sharply.⁶ Gas prices in spot markets have also risen.⁷
- There is evidence of gas pipeline businesses engaging in monopoly pricing, resulting in higher gas prices for users.⁸

In light of this compelling evidence, ECA strongly supports the various reforms that have been undertaken or are underway to deal with gas supply, access to gas pipelines and gas market transparency, including the gas capacity trading reforms, which are the focus of the Reform Package. It is important that these reforms are implemented transparently, in a timely manner and in a way that is faithful to the COAG Energy Council's intention to secure a step-change in the levels of transparency and competition in gas wholesale markets in the long-term interests of consumers.

4. Passing through the benefits of reform to consumers

While the need for reform is clear, the capacity of the reforms to practically deliver benefits for consumers in the form of lower prices and heightened transparency is less clear, and can only be assessed after the event through monitoring of outcomes.

¹ AER, *State of the Energy Market Report*, May 2017, p. 11.

² AER, *State of the Energy Market Report*, May 2017, p. 74. AEMC, *East Coast Wholesale Gas Markets and Pipeline Frameworks Review - Stage 2 Final Report*, 23 May 2016, p. i.

³ AER, *State of the Energy Market Report*, May 2017, p. 74.

⁴ AEMC, *East Coast Wholesale Gas Markets and Pipeline Frameworks Review - Stage 2 Final Report*, 23 May 2016, p. i.

⁵ AEMC, *East Coast Wholesale Gas Markets and Pipeline Frameworks Review - Stage 2 Final Report*, 23 May 2016, p. i.

⁶ AER, *State of the Energy Market Report*, May 2017, p. 74.

⁷ AER, *State of the Energy Market Report*, May 2017, p. 13.

⁸ AER, *State of the Energy Market Report*, May 2017, p. 13. ACCC, *Inquiry into east coast gas market*, April 2016, pp. 99 -106.



The stated objectives of the Reform Package are to improve the efficiency with which transportation capacity is allocated and utilised on contract carriage transmission pipelines and to foster the development of a more liquid market for secondary pipeline capacity. These objectives are sought to be achieved through market-based processes to encourage non-discriminatory trade in secondary capacity and reporting obligations to reduce information asymmetries and aid in the price discovery process, particularly in relation to secondary pipeline capacity.

ECA firmly believes that the long-term interests of consumers are best served through arrangements which promote effective competition, including by rectifying information asymmetry, and therefore, commends these mechanisms.

Nevertheless, a key assumption underlying these mechanisms – as well as the broader gas market reforms – is that they will deliver outcomes that are in the long-term interests of consumers. Specifically, it is assumed that increasing competition and transparency in gas markets will allow gas consumers to know whether the price they are being asked to pay reflects underlying supply and demand conditions. However, there is limited evidence about how the benefits of reforms to reduce wholesale gas and capacity prices, increase transparency and limit the exercise of power in gas markets, particularly by pipeline operators and large retailers, will be passed through to consumers. Further work is required to provide consumers with the confidence that this will occur and how this will occur.

Moreover, through its consultation process with gas users and consumer advocates it has become clear that there is a limited understanding of the detail of the reform proposals, as well as the existing regulatory structure and detailed pricing information. This ‘meta information asymmetry’ leads to concerns that the reform process as well as the existing regulatory structure is at risk of being gamed or captured by the ‘supply industry’ (being gas producers and transmission and distribution pipeline operators) and that, rather than making improvements in the long-term interests of consumers, there is a risk that the practical supremacy of the interests of the supply industry over those of gas consumers and other end users will be perpetuated.

Accordingly, ECA recommends that the GMRG, AER and ACCC continue to closely monitor and report on the effect of the reforms to ensure that the reforms do lead to a decrease in the price of gas delivered to consumers and end-users and that, if so, both this outcome and the effect of the reforms in achieving it are clearly communicated to consumers and large end-users.

5. Maximising coverage of gas market reforms

Limitations on the scope of coverage of gas market reforms could compromise their ability to further the National Gas Objective and, more specifically, effect beneficial change in the long-term interests of consumers.

Under the Reform Package, the scope of coverage of the reforms is limited to contracted, secondary capacity on transmission pipelines. Automatic exemptions are available to distribution pipelines. In addition, exemptions may be sought for transportation facilities that:

- are not providing third party access;
- have a nameplate capacity rating less than 10 TJ/day; or
- are servicing a single shipper.

These criteria have been developed to ensure alignment with Part 23 of the National Gas Rules (NGR), which deals with information disclosure and arbitration arrangements for primary capacity on



gas pipelines, and thereby reduce complexity of administration of Part 23 and the capacity trading reforms.

In ECA's view, the adoption of exemption criteria, which effectively limit the scope of coverage of the Reform Package, should not be based on efforts to reduce administrative complexity for suppliers. Rather, clear and compelling evidence is needed to demonstrate that exemptions from the capacity trading reforms are needed in each case.

In particular, identification of the pipelines that are likely to be covered by the capacity trading reforms and those that are likely to be exempted based on the stipulated criteria is needed, including specification of the percentage of transported gas volumes that would not be covered by and exempted from the reforms. Moreover, evidence is required to demonstrate that the costs associated with compliance with the Reform Package by exempt transportation service providers outweighs the likely benefits – for consumers – if these service providers were to be not to be covered by the reforms.

The possibility of exploitation of the exemption criteria should be explicitly considered and tested by the GMRG, particularly the possibility that the nameplate capacity for individual pipelines could be limited to just under 10TJ/day to remain below the exemption threshold. Given the clear concentration of pipeline ownership, the potential exists for multiple pipelines that individually fall below the 10TJ/day threshold to collectively represent a significant proportion of the market for pipeline capacity so as to allow significant market power to be exerted.

Under the Reform Package, the NGR provides for the AER to revoke exemptions if circumstances change and the exemption criteria are no longer met. The reforms also need to embed an ongoing monitoring role by the AER to ensure that exemptions continue to be justified after being granted. This monitoring role, which should be properly resourced, will help to ensure that coverage under the Reform Package is maximised and exploitation of the exemption criteria is avoided. Users expect the Reform Package to cover a substantial percentage of pipeline capacity.

6. Ensuring effective competition and constraints on the exercise of market power

The Reform Package is designed to drive effective competition in the secondary capacity market and to impose constraints on the exercise of market power by pipeline operators. However, as explained below, the way in which certain proposed reforms are interpreted and practically applied could limit achievement of these objectives.

6.1 Zones

Zones will play a critical role in delivering competitive outcomes under the Reform Package. The zonal model contemplated under the Reform Package is aimed at maximising the pool of prospective buyers and sellers of capacity. Users expect zone decisions to enhance competition.

It is proposed that AEMO will determine the zones that will be used for the capacity trading platform, day-ahead auction and secondary trading reporting framework. The Capacity Transfer and Auction Procedures will set out the arrangements AEMO will use to assess, consult on and determine the zones, while the NGR contain the principles AEMO is to employ when making a decision about zones.

The capacity of the zonal model to deliver competitive outcomes for consumers will depend upon the criteria for determination of zones and the practical application of those criteria by AEMO. While the proposed principles in the NGR for determining zones emphasise the need to account for demand and liquidity, they also specifically contemplate that a zone may consist of a single service point, which could severely limit competition at that point. Moreover, AEMO has broad discretion to group service



points within a zone ‘when to do so seems reasonably likely to promote efficient trade in and use of transportation capacity’.

The very general and, potentially, conflicting principles that apply to the determination of a zone coupled with a broad administrative discretion vested in AEMO when determining zones could lead to less than ideal competitive outcomes. This possibility is likely to be all the more pronounced if AEMO is obliged to consult with stakeholders, including pipeline operators, when determining zones which is expressly contemplated by the NGR.

The NGR also require non-exempt service providers to provide AEMO with the information it reasonably requires for the assessment of the proposed zones and to undertake any modelling or assessment of proposed zones required by AEMO. It will be important that this assessment and modelling is done undertaken rigorously and regularly by AEMO to ensure that dynamic changes in supply and demand for pipeline capacity are appropriately reflected in the zones.

6.2 Standard operational agreements

Standard operational agreements between non-exempt service providers and prospective secondary shippers to effect trades of secondary capacity will also play an important role in creating a competitive environment for the supply of secondary capacity and curbing market power that could be exercised by pipeline operators.

Under the Reform Package, these agreements must be consistent with the new OTS Code. Among other things, the agreements must provide for operational transportation services to be provided on reasonable terms – that is, at prices and on other terms and conditions that, so far as practical, reflect the outcomes of a workably competitive market.

Under the NGR, the AER will have power to assess the compliance of a service provider’s standard operational agreement with the NGR and the Code, either of its own volition or in response to a concern raised by a shipper. The AER will also have the power to require changes to the standard operational agreement if it finds the provisions are inconsistent with the Code or the NGR.

Nevertheless, the effectiveness of the AER’s power to ensure standard operational agreements comply with the regulatory framework will rest on when and how regularly that power is exercised. Ideally, the AER should conduct an *ex ante* review of all standard operational agreements before the capacity trading reforms come into effect. The AER should also undertake ongoing monitoring to ensure that any new standard operational agreements that are established are also compliant. Once again, this monitoring role should be properly resourced.

6.3 Amendment of facility agreements

The Reform Package also seeks to address contractual limitations on capacity trading that are reflected in existing facility agreements between pipeline operators and shippers through a ‘request and negotiate’ framework.

The requirement imposed on transportation service providers to provide shippers with an amending agreement within 30 days of a request that enables the shipper to sell capacity will help to remove barriers to trade of capacity. However, the lengthy period within which the service provider has to respond to a shipper’s request coupled with provisions in the NGR requiring both parties to agree to the terms of the amending agreement could mean that agreement is never reached or agreement occurs too late to allow timely trade in secondary capacity to occur. This outcome would defeat the purpose of the reforms. Accordingly, ECA suggests a shorter, more reasonable timeframe of 15 days within which transportation service providers are to provide shippers with an amending agreement.



6.4 Auction market conduct rules

Under the Reform Package, auction participants will be required to comply with general requirements not to act fraudulently, dishonestly or in bad faith. To ameliorate the gaming risks associated with nominations and renomination rights (e.g. capacity holders deliberately withholding capacity from the auction by over-nominating on gas day D-1 then re-nominating down on gas day D, or try to cause another shipper to be curtailed on the gas day by renominating up on the gas day), shippers will be prohibited from making a nomination or renomination that is false, misleading or likely to mislead.

It will be critical that relevant and credible information is available or required to be made available under the Reform Package to allow the AER to make timely determinations as to whether the auction market conduct rules have been breached. The sanctions for non-compliance should be commensurate with the seriousness of such breaches. Users are expecting competition to be enhanced through the Reform Package.

6.5 Participation in secondary capacity markets

The Reform Package includes certain administrative requirements with which shippers wishing to participate in the secondary capacity market trading must comply, specifically:

- Participation in day-ahead auction: Shippers that wish to participate in the day-ahead auction must execute an Auction Agreement with AEMO, which will set out the terms of participation in the auction, including the prudential and settlement obligations.
- Participation in capacity trading platform: Primary and secondary shippers that want to use the capacity trading platform will need to become members of the Gas Supply Hub (GSH) by executing a Membership Agreement with AEMO and be registered as trading participants. Through the Membership Agreement, shippers will become a party to the Exchange Agreement, which is a multilateral agreement that sets out the terms of participation in the GSH and the terms governing transactions entered into through the exchange.
- Shipper will have to have Operational Transportation Service Agreement (TSA) in place: If a shipper procures secondary capacity through the exchange or day-ahead auction, the trade will be given effect through an operational transfer. A secondary shipper will, therefore, need to have entered into an operational TSA with the transportation service provider.
- Allocation agreement: If a secondary shipper procures capacity through the exchange or day-ahead auction and wants to use a multi-user receipt or delivery point, it may need to become a party to any allocation agreement at that point(s). This agreement sets out the rules the allocation agent is required to use to allocate gas between shippers at the receipt or delivery point.
- Other services: In some cases, a secondary shipper may also require access to other transportation related services that are not available on the exchange or through the auction and will need to enter into arrangements with the relevant service provider for the provision of those services or to access to a receipt or delivery point that is controlled by a third party and will need to enter into arrangements with that party to ensure they can utilise those points.

These administrative requirements with which shippers will need to comply could create a barrier to participation in the secondary capacity market. The agreements and processes for entry into those agreements should be as simple and as user-friendly as possible to minimise barriers to entry.



7. Redressing power imbalance through appropriate governance arrangements

In establishing the contractual framework within which trades of secondary capacity will occur, the Code will also play a critical role in delivering the objectives of the Reform Package. Accordingly, it will be important to ensure that governance arrangements around development and amendment of the Code are not captured and/or exploited by vested interests represented on the OTS Code Panel.

The power of the AER to approve, reject and remit proposed changes to the Code and to change the Code on its own initiative, will help to redress power imbalances that may be embedded in the composition of the OTS Code Panel. The AER will also have an important role in ensuring compliance and enforcement with the OTS Code role in relation to the Code. Consideration should be given as to how the integrity and credibility of this dual role can be supported and maintained.

8. Ensuring integrity, accessibility and usability of reported information

The Reform Package includes some important measures to enhance transparency, including:

- the reporting framework for secondary capacity trades, which requires the publication of information on secondary capacity trades shortly after they occur;
- a requirement for AEMO to publish auction results and other auction related information on the Bulletin Board; and
- a requirement for allocation agents to provide AEMO with their contact details and other information on allocation agreements.

The requirement that participants in the capacity trading market report information to AEMO for publication will help enhance market transparency. However, transparency on its own will not deliver benefits for consumers unless the information generated by these reporting obligations is accessible and digestible and the integrity of the information can be assured.

The AER's role in proactively monitoring and ensuring compliance with these reporting obligations on an ongoing basis will play a critical role in achieving these outcomes. Once again, the AER should be properly resourced to ensure that ongoing monitoring is effective in detecting and deterring non-compliance.

9. Effective compliance and enforcement of the regulatory framework

More generally, the success of the regulatory framework will rest, at least in part, on effective compliance and enforcement activity by the AER. Under the Reform Package, the AER's compliance and enforcement functions will be expanded to include monitoring and ensuring compliance of:

- non-exempt service providers with:
 - the obligations to publish standard operational agreements and to offer to enter into such agreements in Part 24 of the NGR;
 - the obligation for the content of the standard operational agreements to comply with the requirements of the Code and Part 24 of the NGR;
 - the cost recovery principles in Part 24 of the NGR; and



- new reporting obligations for the Bulletin Board in Part 18 of the NGR and day-ahead auction in Part 25 of the NGR.
- shippers with the nomination and renomination obligations in the NGR and other market conduct rules applicable to the day-ahead auction in Part 25 of the NGR;
- sellers of secondary capacity in bilateral trades to offer buyers the option of using an operational transfer in section 228I of the NGL;
- shippers with new secondary trading reporting obligations in Part 18 of the NGR; and
- allocation agents with the new Bulletin Board reporting obligations in Part 18 of the NGR.

The AER's power to monitor and secure compliance should be activated before non-compliant and, potentially, anti-competitive behaviour or arrangements have become entrenched. This implies a proactive, strategic and well-resourced compliance and enforcement program. Regular reporting on compliance and, where necessary, appropriate action by the AER will help to send strong signals to regulated entities about the importance of compliance and will hopefully deter future non-compliance.

10. Outcomes-based cost recovery by service providers

It has been proposed that service providers should have a reasonable opportunity to recover the incremental costs associated with establishing and maintaining standard operational agreements and the systems and processes required to comply with its obligations under the NGR and the Capacity Transfer and Auction Procedures, provided that the costs must not be recovered more than once and any auction revenue must be treated as a contribution to cost recovery.

The NGR also requires that any charges levied by service providers must, as far as practicable, reflect the outcomes of a workably competitive market, allocate the costs among shippers in a reasonable manner, and provide for the recovery of costs over time in a manner that promotes efficient trade in, and utilisation of, capacity. The AER will have the power to conduct a review of a service provider's charges and require amendments if it finds that they do not comply with the principles in the NGR.

Notably, the AER's review of a transportation service provider's charges is only triggered if the AER has concerns about their level or if concerns are raised by an interested party. Despite the costs associated with an *ex ante* review of charges by the AER, the GMRG should consider whether the benefits would outweigh the costs, particularly from consumers' perspective. Such a review could be conducted by an independent auditor to confirm that the service provider is only seeking to recover incremental costs, at the expense of the service provider.

Moreover, the basis for recovery of costs associated with compliance with the regulatory framework by service providers should be based predominantly on outcomes, rather than inputs. More specifically, the basis of a service provider's costs recovery should be linked to a clear demonstration of compliance with the objectives and details of the regulatory framework as a pre-condition to claiming, input costs. In addition, the service provider should be required to demonstrate in tangible terms how the costs claimed by the service provider help deliver these outcomes. These requirements will help to avoid 'gold plating' and over-charging, which will ultimately have a detrimental impact on consumers.



11. Timely review of impact and effectiveness of reforms

Review of the impact and effectiveness of the Reform Package and broader gas market reforms in achieving the National Gas Objective and, particularly, serving the long-term interests of consumers following implementation, is needed sooner, rather than later to avoid unintended and/or perverse market outcomes. The review, which should be hard-wired into the regulatory framework, should be based on accurate information that can form a sound and reasonable basis for conclusions and recommendations regarding any amendments that might be needed to the new gas market arrangements.

12. Other Matters – section 50 *Competition and Consumer Act 2010*

In the course of ECA's consultations, it became clear that some gas users believe that certain holders of pipeline capacity are attempting to monopolise capacity in particular pipelines in their own economic interests.

While the proposed reforms may result in some of that excess capacity being released to the market on a day-ahead basis, there is concern that day-ahead auctions on their own will not provide sufficient certainty to enable firm orders for large volumes of capacity to be placed and delivered.

Of itself, direct or indirect acquisition of pipeline capacity may substantially lessen competition in downstream markets and thus contravene section 50 of the *Competition and Consumer Act 2010*, if such capacity is an asset capable of being acquired within the meaning of s50.⁹

ECA is not aware of the ACCC having previously considering this issue and recommends that the ACCC be requested¹⁰ to investigate and consider whether any current capacity holdings have been acquired in contravention of section 50. If so, the ACCC should consider divestiture of capacity holdings either by way of court orders or enforceable undertakings in addition to any other appropriate remedies and penalties available under the competition law.

13. Conclusion

Thank you for the opportunity to make this submission on the detailed design and implementation of these important reforms. Please do not hesitate to contact Lynne Gallagher, lynne.gallagher@energyconsumersaustralia.com.au or on 02 9220 5500 if you would like to discuss these matters further.

Yours sincerely,

Signed for and on behalf of
Energy Consumers Australia

⁹ In the form of section 50 both prior to and after the amendments made by the *Competition and Consumer Amendment (Competition Policy Review) Act 2017*, which took effect on 6 November 2017.

¹⁰ Either as part of the current inquiry into gas supply arrangements in Australia, or as a stand-alone enforcement activity, as the ACCC considers appropriate.