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**APPLICATION FOR AUTHORISATION  
OF  
MARKET AND SYSTEM OPERATIONS RULES**

Application To The Australian Competition And Consumer Commission For  
Authorisation Under Part VII Of The Trade Practices Act 1974

**VENCorp**

**17 May 2002**

**MARKET AND SYSTEM OPERATIONS RULES**  
**SUBMISSION TO THE AUSTRALIAN COMPETITION AND CONSUMER COMMISSION**  
**RELATING TO AN APPLICATION FOR AUTHORISATION**

This is the Submission comprising 86 pages referred to in each of the applications for authorisation in respect of the Market and System Operations Rules, namely:

- (a) Form A: Exclusionary provisions dated 17 May 2002;
- (b) Form B: Agreements affecting competition dated 17 May 2002; and
- (c) Form E: Exclusive dealing dated 17 May 2002.

Signed for and on behalf of VENCorp

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Mr Terry Grimwade  
Acting Chief Executive Officer  
VENCorp

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## **1 APPLICATION**

### **1.1 Introduction**

The purpose of these applications and submission is to seek a renewal of the authorisation of the Victorian gas Market and System Operations Rules (the "**MSO Rules**") for the 10 year period commencing 1 January 2003.

The MSO Rules are the current rules under which the wholesale gas market and gas transmission system are operated in Victoria. The MSO Rules were enacted under the Gas Industry Act 1994 ("**1994 GIA**"), and additionally form part of Victorian Energy Networks Corporation ("**VENCorp**") access arrangement under the National Third Party Access Code for Natural Gas Pipelines ("**Code**").

On 22 December 1997 VENCorp lodged applications for authorisation (numbers: A90646, A90647 and A90648) of the MSO Rules. The applications were submitted under Part VII of the Trade Practices Act 1974 (Cth) ("**TPA**") and the Competition Code of Victoria as defined in the Competition Policy Reform (Victoria) Act 1995 (Vic) ("**Competition Code**") and were accompanied by a supporting submission ("**1997 Submission**").

On 19 August 1998 the Commission granted authorisation under a determination of that date ("**1998 Determination**") for chapters 2 to 6 (inclusive) of the MSO Rules. The authorisation was granted until 1 January 2003 ("**Current Authorisation**").

As the Commission is aware, the Current Authorisation was granted after extensive public consultation. Twenty-six parties made submissions on the authorisation and the Commission also undertook discussions with numerous parties. The Commission issued a draft determination on 28 May 1998 and on 17 June 1998 VENCorp amended the MSO Rules. A pre-determination conference was then held on 6 July 1998 with further submissions received by thirteen parties before the final 1998 Determination.

The 1998 Determination contained numerous conditions requiring further amendments to the MSO Rules and various reviews to be conducted by VENCorp<sup>1</sup>. These reviews and amendments have taken place as required and the revised MSO Rules were made by Order in Council dated 2 February 1999.

From the outset, the MSO Rules were intended to be capable of evolving to meet the needs of a dynamic market. VENCorp's rigorous and effective review and consultation processes have ensured that the MSO Rules achieve this important objective. Since VENCorp's initial application in 1997, it has made 13 applications for amendment to the MSO Rules, with each amendment accepted by the Commission as a minor variation to the Current Authorisation. This reflects VENCorp's sound governance structure, effective reporting and approval processes, and thorough review and consultation processes.

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<sup>1</sup> 1998 Determination at Section 16.

By 1 January 2003 the MSO Rules will have been in operation for approximately four years, creating a live, functioning wholesale gas market, and forming a fundamental and integral part of the gas industry and market in Victoria. Other contracts and regulatory instruments pertaining to the gas transmission system have evolved around the MSO Rules, including:

- (a) the Retail Gas Market Rules<sup>2</sup> to enable full retail competition on the Principal Transmission System ("PTS");
- (b) the Victorian access arrangements relating to the PTS;
- (c) the Service Envelope Agreement<sup>3</sup>;
- (d) the gas transportation deeds; and
- (e) all contracts entered into in the retail market.

Victorian law also enshrines VENCorp's role as independent system operator of the Victorian gas transmission system<sup>4</sup>. VENCorp's role in this regard will continue unless amended by statute<sup>5</sup>.

## **1.2 Applications**

These applications for authorisation are made by VENCorp under Part VII of the TPA and the Competition Code, in respect of the MSO Rules (including any amendments as described in **section 1.4**), such authorisation to take effect from 1 January 2003.

These applications are made under:

- (a) sub-section 88(1) of the TPA and sub-section 88(1) of the Competition Code for an authorisation under those sub-sections to make and give effect to any contract, arrangement or understanding, constituted by or under the MSO Rules, where a provision of the proposed contract, arrangement or understanding would or might be an exclusionary provision within the meaning of sections 45 and 4D of the TPA and sections 45 and 4D of the Competition Code;

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<sup>2</sup> Retail Gas Market Rules means the rules approved by the Essential Services Commission ("ESC") on 5 October 2001 and varied on 17 January 2002 under section 65 of the GIA.

<sup>3</sup> Service Envelope Agreement means an agreement for the purposes of Clause 5.3.1(a) of the MSO Rules, entered between GasNet Australia (Operations) Pty Limited ("GasNet"), GasNet Australia (NSW) Pty Ltd and VENCorp, dated 14 January 1999.

<sup>4</sup> Gas Industry Act 2001, and MSO Rules enforced under Part 8 of that Act. At the date of this submission, the gas transmission system comprises the principal transmission system owned by GasNet.

<sup>5</sup> VENCorp notes that section 205 of the Gas Industry Act 2001 requires a review of Part 8 of the Act, including the role of VENCorp, to be undertaken by 31 December 2007. If that review concluded that fundamental changes were required to the role of VENCorp, the Victorian Government would need to develop and enact statutory amendments to implement any such changes.

- (b) sub-section 88(1) of the TPA and sub-section 88(1) of the Competition Code for an authorisation under those sub-sections to make and give effect to any contract, arrangement or understanding constituted by or under the MSO Rules, where a provision of the proposed contract, arrangement or understanding would or might have the effect of substantially lessening competition within the meaning of section 45 of the TPA and section 45 of the Competition Code (including any deemed lessening of competition through price fixing arrangements within the meaning of section 45A of the TPA and section 45A of the Competition Code); and
- (c) sub-section 88(8) of the TPA and sub-section 88(8) of the Competition Code for an authorisation under those sub-sections to make and give effect to the MSO Rules to the extent that making the MSO Rules or giving effect to a provision of the MSO Rules, involves engaging in conduct that would or might constitute the practice of exclusive dealing within the meaning of section 47 of the TPA and section 47 of the Competition Code.

### **1.3 MSO Rules**

These applications seek authorisation for the whole of the MSO Rules.<sup>6</sup>

The MSO Rules are a legal instrument, having been made initially under section 48N of the 1994 GIA by Order in Council on 2 February 1999 and published in the Victorian Government Gazette dated 4 February 1999 (Gazette No. G5). On 23 February 1999, 10 March 1999, 28 April 1999 and 29 June 1999, further amendments were made to the MSO Rules by Order in Council pursuant to section 48N of that Act.

The MSO Rules are now governed by Part 4 of the Gas Industry Act 2001 ("GIA"). They will continue in force beyond the expiry of the Current Authorisation, as will other contracts, regulatory instruments and retail market rules designed around the MSO Rules.

The main purposes of the MSO Rules are to:

- (a) provide for a wholesale market for the conveyance of gas through the PTS;
- (b) provide for a wholesale market for the balancing of gas flows in or through the PTS;
- (c) regulate the operation of the PTS by VENCORP, including regulation of system security by VENCORP; and
- (d) provide mechanisms for resolution of disputes between Participants<sup>7</sup> or between VENCORP and Participants regarding the application or interpretation of, or failure to comply with, the MSO Rules.

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<sup>6</sup> Refer also to **section 1.4** regarding VENCORP's requested amendments to the MSO Rules as part of its revised access arrangement for the PTS.



The MSO Rules achieve this through establishing rules and procedures covering:

- (a) participation in the wholesale market – i.e. who is involved;
- (b) requirements for participation (e.g. prudential requirements);
- (c) nominations and bidding processes;
- (d) scheduling of gas;
- (e) setting of wholesale gas spot market prices;
- (f) metering;
- (g) settlement of the wholesale market;
- (h) management of system security;
- (i) dispute resolution; and
- (j) rule change process.

While the MSO Rules do not relate directly to the retail market for gas, they help promote competition in the retail market, and full retail competition assumes the continued operation of the MSO Rules.

The MSO Rules form an integral part of the legal and regulatory framework and the structure of the Victorian gas industry that were implemented by the Victorian Government in the late 1990s in order to introduce a competitive gas market.

The provisions of the MSO Rules are interrelated. The effectiveness of each is dependent on the other. Accordingly, VENCORP submits that the MSO Rules should be considered by the Commission as a whole and VENCORP seeks authorisation of the MSO Rules as a whole.

#### **1.4 Form of MSO Rules**

As the Commission is aware, VENCORP and GasNet have both lodged with the Commission proposed revised access arrangements for the PTS.

VENCORP is proposing an access arrangement based on the current MSO Rules although some minor changes are necessarily required as part of the revision of VENCORP's access arrangement. These minor changes are needed to give effect to

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<sup>7</sup> Participants being all those parties currently registered with VENCORP as participants and whose names and addresses are listed in **Schedule 2** to this Submission and all future parties who are registered as a participant in one of the categories listed in **Schedule 1** to this Submission.

the changes in the budget and fee setting process that VENCorp is proposing as part of the revision to the access arrangement<sup>8</sup>.

Further, in lodging its revised access arrangement, VENCorp had assumed that, as with GasNet's current access arrangement, GasNet would continue to describe in its access arrangement the transmission services and capacity provided to VENCorp, as a current user of these services. VENCorp has asked the Commission to require that GasNet describe the services it provides, or include in its access arrangement either the Service Envelope Agreement itself, or the key obligations from that agreement.

In the absence of a clear commitment from GasNet to continue to make the PTS available to VENCorp for VENCorp to operate in accordance with the MSO Rules (as is currently incorporated in the definition of GasNet's tariffed transmission services in GasNet's current access arrangement), further amendments may be required to the MSO Rules to ensure:

- (a) the continuing availability of the PTS upon which the MSO Rules themselves and VENCorp's access arrangement is predicated; and
- (b) GasNet's co-operation in facilitating VENCorp's role under the GIA and MSO Rules<sup>9</sup>.

The current version of the MSO Rules is attached as **Schedule 3** to this submission, which includes, in text boxes, clauses that have been authorised by the Commission but which remain inoperative until gazetted coincident with implementation of full retail competition. **Schedule 4** details amendments to the MSO Rules that will be determined by the Commission's decisions regarding the revised access arrangements.

Given that the final form of VENCorp's and GasNet's access arrangements are as yet unknown, these applications seek authorisation of:

- (a) the MSO Rules in their current form, including rule changes previously authorised by the Commission and annotated in the current rules for implementation at a future date; and
- (b) such amendments as may be required by, or provided for, in the final access arrangements relating to the PTS.

As part of its ongoing review of the MSO Rules VENCorp may seek authorisation of further changes to the MSO Rules during the period the Commission is considering these applications.

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<sup>8</sup> Amendments are required to Rules 1.1.3, 1.2.1, 2.6, 2.7, 5.3.1, 5.3.4 and 11.

<sup>9</sup> If required, a proposed change to rule 5.3.1 of the MSO Rules to achieve this is set out in **Schedule 4**.

## **1.5 Summary of Current Authorisations**

On 19 August 1998, the Commission granted authorisation for applications A90646, A90647 & A90648 in respect of Chapters 2, 3, 4, 5 and 6 of the MSO Rules provided that a number of conditions were met including reviews prior to market commencement, rule changes and development of guidelines.

Each condition was met by VENCORP, such that the authorisation became effective and remains in force until 31 December 2002.

In many instances, the reviews have led to further rule changes which have also been approved by the Commission, with corresponding variations to the initial authorisation.

## **1.6 Variations Accepted by the Commission to the Current Authorisation**

In a developing competitive market within an energy industry structure that is continuing to evolve, the MSO Rules necessarily are subject to ongoing development and amendment.

Amendments to the MSO Rules are made in accordance with section 52 of the GIA. The GIA provides that the MSO Rules may be amended by the Governor in Council, or by VENCORP after consultation in accordance with the MSO Rules. VENCORP must follow the rule change procedures specified in Chapter 8, that require all amendments to be approved by the Commission.

Since the initial authorisation, VENCORP has applied for and the Commission has subsequently granted 13 minor variations to the authorisation.

As is evident by this history, the authorisation of the MSO Rules has been the subject of continual re-assessment by the Commission throughout the period of the Current Authorisation. In all cases, the Commission has subsequently approved the variations.

The experience also demonstrates the effectiveness of the industry consultation processes for developing the MSO Rules. In all cases, the regulatory processes have been demonstrated to be effective and efficient. The processes are simple, effective, and straightforward, so much so that VENCORP has been able to conduct its business in this regard without need to resort to legal support.

The MSO Rules apply to the gas transmission and distribution systems as defined in the GIA, and demonstrate a significant efficiency to be obtained from having a uniform standard of conduct when considering the complexity that such evolution would have involved should this have been dealt with in a purely contractual context.

## **1.7 Period of Authorisation**

### **1.7.1 Requirements under the TPA**

Section 91(1) of the TPA indicates that an authorisation may be expressed to be in force for a period as specified in the authorisation and will remain in force for that period. The Current Authorisation is in force until 1 January 2003.

### **1.7.2 Proposed Period of Authorisation**

If the Commission decides that the authorisation pursuant to these applications should be in force for a specified period, VENCorp submits that the authorisation should remain in force for a period of ten years, being from 1 January 2003 until 31 December 2012.

When the Current Authorisation was sought in 1997/98, no competitive gas market existed in Victoria and the Victorian gas industry was being completely restructured. Accordingly, some interested parties argued that any authorisation should be granted for a period of less than ten years to allow for evaluation of the effectiveness of the MSO Rules.<sup>10</sup>

VENCorp submits that the current position is completely different from that in 1998. At that time there was uncertainty regarding how the MSO Rules would impact upon the gas market, industry and Participants. That uncertainty no longer exists.

The MSO Rules have been in operation for over three years. The operation and effectiveness of the MSO Rules are now known to all Participants. Further, since implementation of the MSO Rules:

- (a) the Victorian regulatory and legal framework has been structured on a market carriage system incorporating the MSO Rules as a fundamental part of that system;
- (b) significant investment has been made based on a market carriage system and the continued operation of the MSO Rules<sup>11</sup>;
- (c) clear public benefits have been achieved; and
- (d) the review processes incorporated in the MSO Rules and the consultative forums established by VENCorp, have been shown to be highly effective in addressing the need for change or refinement in the MSO Rules as the Victorian market develops. (In its 1998 Determination the Commission

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<sup>10</sup> 1998 Determination at page 157.

<sup>11</sup> Including, for example, privatisation of the industry, Participant business systems, VENCorp systems for market system and operation, investments in systems and arrangements for full retail contestability, new market entrants and gas fired generation.

expressed the belief that deficiencies emerging in the MSO Rules could be handled through the MSO Rules rule change process.<sup>12)</sup>

It is VENCORP's submission that a ten year period would:

- (a) provide a balance between the need for certainty for Participants and investors, and the need for flexibility of market operations;
- (b) provide certainty in the evolving gas market, recognising that uncertainty affects price and investment;
- (c) recognise the efficacy of the ongoing reviews and consultative forums established pursuant to the MSO Rules<sup>13</sup> to manage the necessary evolution of the MSO Rules to manage changing industry and market requirements;
- (d) recognise that ongoing changes to MSO Rules already are subject to the Commission's approval, assessment of any impact on the authorisation, and variation of the authorisation if required;
- (e) avoid unnecessary market disruption and significant regulatory costs that may result from further reviews of the MSO Rules within the ten year period;
- (f) be consistent with the duration of comparable market rules in electricity (i.e. the National Electricity Code); and
- (g) be consistent with the regulatory review structure in electricity, where network price reviews are not aligned with reviews of the competition authorisation.

It is also important to note that a statutory review of Part 8 of the GIA must be undertaken during 2007, with a report due to be delivered to the relevant Minister on or before 31 December 2007. That review will examine the current role and functions of VENCORP, with particular regard to the competitiveness of markets for or in relation to gas.

VENCORP submits that a ten year authorisation period enables an objective statutory review to be completed in 2007, avoiding the practical and resourcing tensions that would be created if the Commission, VENCORP or interested parties, had to address two very different and possibly conflicting reviews at the same time.

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<sup>12</sup> 1998 Determination at page 160. Amendments to the MSO Rules are made in accordance with section 52 of the GIA. The GIA provides that the MSO Rules may be amended by the Governor in Council, or by VENCORP after consultation in accordance with the MSO Rules. VENCORP must follow the rule change procedures specified in Chapter 8 of the MSO Rules themselves, which procedures require that all amendments by VENCORP to the MSO Rules be approved by the Commission.

<sup>13</sup> Refer to **section 3** for a description of such forums.

Should the review result in a fundamental change to the role of VENCorp as independent system operator, then a new alternative model would need to be developed, and implemented through statutory amendment. If an alternative model is required, new authorisations would be sought, if necessary, at that time. A ten year period would enable a review of the authorisation to be initiated on its merits on an as-needs-basis, rather than prescribing it at a time which may not be appropriate.

VENCorp notes it is not uncommon for the Commission to grant authorisations for lengthy periods in appropriate cases, as illustrated by the Commission's determinations in respect of the National Electricity Code (10 years), the North West Shelf Project (7 years) and Mereenie Producers (effectively 10 years) authorisation applications.<sup>14</sup>

## **1.8 Parties to be Covered by the Authorisation Applications**

As with the Current Authorisation, these authorisation applications are made by VENCorp, and not on behalf of any other corporation or other person. However, any contract, arrangement or understanding constituted by or under the MSO Rules will be between VENCorp and a Participant (as defined in the MSO Rules and including any future Participants) or Participants, or between Participants. Any exclusive dealing conduct constituted by giving effect to the MSO Rules may be engaged in by Participants as well as by VENCorp. VENCorp submits that the benefit of any authorisation extend not only to VENCorp but also to all Participants.

As previously submitted in 1997, the TPA contains several provisions which could facilitate the attainment of this objective.

### **1.8.1 Sub-section 88(6)**

Sub-section 88(6) provides:

*"An authorisation granted by the Commission to a person under any of the preceding provisions of this section to:*

- (a) make a contract or arrangement or arrive at an understanding;*
- (b) give effect to a provision of a contract, arrangement or understanding; ...*

*has effect as if it were also an authorisation in the same terms to every other person named or referred to in the application for the authorisation as a party to the contract, arrangement or understanding or as a proposed party to the proposed contract, arrangement or understanding ..."*

The 1998 Determination authorised the MSO Rules on the basis that, pursuant to sub-section 88(6), the benefit of any authorisation granted by the Commission under

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<sup>14</sup> National Electricity Code Determinations – 2001, North West Shelf Project Determination – 29 July 1998 and Mereenie Producers – Gasgo Sales Agreement Determination – 7 April 1999.

sub-section 88(1) should apply to any persons who would apply to be registered as Participants under the MSO Rules.

Consistent with the Current Authorisation, VENCORP now submits that the applications made in Form A and Form B should apply to all existing Participants as well as any future Participants, who apply to be registered as Participants under the MSO Rules.

### **1.8.2 Sub-section 88(10)**

Sub-section 88(10) provides:

*"An authorisation to a corporation under sub-section (1) may be expressed so as to apply to or in relation to another person who:*

- (a) in the case of an authorisation to make a contract or arrangement or arrive at an understanding – becomes a party to the proposed contract or arrangement at a time after it is made or becomes a party to the proposed understanding at a time after it is arrived at; or*
- (b) in the case of an authorisation to give effect to a provision of a contract, arrangement or understanding – becomes a party to the contract, arrangement or understanding at a time after the authorisation is granted."*

Consistent with the Current Authorisation, in relation to the authorisation sought under sub-section 88(1), VENCORP requests that the authorisations granted pursuant to these applications be expressed so as to apply to or in relation to each Participant who:

- (a) in the case of an authorisation to make a contract, arrangement or understanding constituted by or under the MSO Rules, becomes a party to that contract, arrangement or understanding at any time in the future; or
- (b) in the case of an authorisation to give effect to a provision of a contract, arrangement or understanding constituted by or under the MSO Rules, becomes a party to the contract, arrangement or understanding by registering with VENCORP as a Participant at a time after the authorisation is granted.

### **1.8.3 Sub-section 88(13)**

Sub-section 88(13) provides:

*"An application made to the Commission under this section for an authorisation in relation to a particular contract or proposed contract .....may be expressed to be made also in relation to another contract or proposed contract that is or will be, or in relation to two or more other contracts or proposed contracts that are or will be, in similar terms to the first-mentioned contract or proposed contract and, where an application is so expressed, the Commission may grant a single authorisation in respect of all the contracts or proposed contracts or may grant*

*separate authorisations in respect of any one or more of the contracts or proposed contracts."*

Sub-section 88(15) defines "Contract" for the purpose of sub-section 88(13) to include an arrangement, understanding, industry code of practice or covenant.

As in the 1997 Submission, VENCORP submits that sub-section 88(13) applies to any applications made to the Commission under section 88 generally. As previously submitted, VENCORP now submits that to the extent that any contract, arrangement or understanding is constituted by the making of or giving effect to the MSO Rules between VENCORP and a Participant, or between two Participants, such contract, arrangement or understanding should be regarded as a particular "contract or proposed contract" within the meaning of sub-section 88(13). Upon any similar contract, arrangement or understanding being formed when a person is admitted as a Participant under the MSO Rules, it is submitted that such contract, arrangement or understanding may be regarded as "another contract or proposed contract..... in similar terms to the first mentioned contract or proposed contract" within the meaning of sub-section 88(13).

In its applications, VENCORP has requested that any authorisation granted by the Commission be expressed as a single authorisation in respect of all such contracts, arrangements or understandings as may be constituted by or under the MSO Rules. A current list of Participants appears as Schedule 2 to this Submission. However, the identity of any future Participant is not known at the time of these applications. VENCORP notes however that as provided for in paragraph (b) of sub-section 88(14), if an authorisation is granted by the Commission in respect of each proposed contract, arrangement or understanding, that authorisation would be deemed to be expressed to be subject to a condition that any party to such a proposed contract will, when so required by the Commission, furnish the Commission with the names of all parties to that proposed contract.

## **1.9 Contact Details**

The address for service of documents on VENCORP in regard to these applications is:

Mr Terry Grimwade,  
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## **2 CRITERIA FOR AUTHORISATION**

### **2.1 Statutory Test for Substantial Lessening of Competition and Exclusive Dealing**

This section sets out VENCorp's understanding of the relevant statutory tests, and hence the rationale for the arguments that follow.

Sub-section 90(6) provides that the Commission must not grant an authorisation under sub-section 88(1) or 88(8) in respect of a proposed contract, arrangement or understanding or proposed conduct which:

- (a) would or might have the effect of substantially lessening competition; or
- (b) would constitute exclusive dealing (other than conduct to which sub-section 47(6) or (7) applies),

unless it is satisfied in all the circumstances that:

- (a) the contract, arrangement or understanding or conduct would result, or be likely to result, in a benefit to the public; and
- (b) the benefit would outweigh the detriment to the public constituted by any lessening of competition that would result, or would be likely to result, from the contract, arrangement or understanding or proposed conduct.

### **2.2 Statutory Test for Exclusionary Provisions and Third Line Forcing**

Sub-section 90(8) provides that the Commission must not grant an authorisation under sub-section 88(1) or (8) in respect of:

- (a) a provision of a proposed contract, arrangement or understanding that is or may be an exclusionary provision; or
- (b) proposed conduct which amounts to third line forcing under sub-section 47(6) or (7),

unless the Commission is satisfied in all circumstances that the proposed provision or the proposed conduct would result, or be likely to result, in such a benefit to the public that the proposed contract, arrangement or understanding or proposed conduct should be allowed.

### **2.3 Application of Statutory Tests**

As the Commission is aware, and as previously submitted in the 1997 Submission, while the tests under sub-section 90(6) and sub-section 90(8), exhibit some variation in language, the Australian Competition Tribunal ("**Tribunal**") has expressed the view that:

*"... the practical application of this language gives rise to a test that is essentially the same necessitating the establishment of likely benefit to the public, and a*

*weighing against that benefit of any likely detriment to the public from lessening competition.”<sup>15</sup>*

As submitted in 1997, the mere act of making application for authorisation is not to carry with it any presumption as to the arrangements in question contravening a provision of Part IV of the TPA.

The assessment of whether or not the Commission may grant an authorisation involves the following key elements:

- (a) identification of the relevant markets;
- (b) an examination of the public benefits arising from the arrangements or conduct in question;
- (c) an examination of any detriment constituted by any lessening of competition; and
- (d) a weighing of the public benefits against any detriments.

## **2.4 Statutory Definition of Markets**

Section 4E of the TPA defines a “market” as meaning:

*“a market in Australia and, when used in relation to any goods or services, includes a market for those goods or services and other goods or services that are substitutable for, or otherwise competitive with, the first mentioned goods or services.”*

Markets are defined by reference to:

- (a) product type;
- (b) geographical scope; and
- (c) functional level.

Consideration should also be given to time and likely future developments in relevant markets.

## **2.5 1998 Determination - Market Definitions**

In 1998 the Commission considered the key questions for market definition to be:

- (a) Is the product market limited to gas, or is there a broader energy market?

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<sup>15</sup> Re: Media Council of Australia (No. 2) (1987) ATPR 40-774.

- (b) Is the geographic boundary of the market limited to Victoria or does it extend interstate?
- (c) What are the functional activities in the market relevant to assessing the application? Is transmission a functional level of the posited gas or energy markets or is it a separate "product" market in its own right?<sup>16</sup>

The Commission concluded in its 1998 Determination that the relevant markets for the purpose of VENCorp's authorisation applications consisted of the following dimensions:

- (a) Product markets: Gas and gas transmission.
- (b) Geographical markets: South-east Australia for both products, but appreciating that physical constraints will limit the flow of gas unless further augmentation in New South Wales and Victoria is undertaken.
- (c) Functional market: In relation to the gas market, the wholesaling of gas by producers to retailers and large industrial customers.<sup>17</sup>

The Commission has adopted similar market definitions when granting authorisations in relation to the North West Shelf project<sup>18</sup> and the Mereenie Producers – Gasgo Sales Agreement<sup>19</sup>.

VENCorp submits that:

- (a) the previous decisions of the Commission and the Tribunal support market definitions as determined by the Commission in its 1998 Determination; and
- (b) there have been further developments since 1998 that support the definitions adopted in the 1998 Determination.

## **2.6 Defining Public Benefits and Detriments**

Public benefits and detriments arising from the MSO Rules must be assessed within the context of the relevant markets.

What constitutes a "public benefit" or "detriment" is not defined under the TPA. Both terms however have been considered by the Tribunal on numerous occasions and it has been considered that both terms should be given a wide ambit.

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<sup>16</sup> 1998 Determination at page 12.

<sup>17</sup> 1998 Determination at page 18.

<sup>18</sup> ACCC Determination – North West Shelf Project – 29 July 1998 at page 26.

<sup>19</sup> ACCC Determination – Mereenie Producers – Gas Sales Agreement – 7 April 1999 at page 31.

In *Victorian Newsagency*<sup>20</sup> the Tribunal discussed public benefit in the following terms:

*"Public benefit has been, and is, given a wide ambit by the Tribunal as, in the language of QCMA ... "anything of value to the community generally, any contribution to the aims pursued by the society including as one of its principal elements (in the context of trade practices legislation) the achievement of the economic goals of efficiency and progress". Plainly the assessment of efficiency and progress must be from the perspective of society as a whole: the best use of society's resources. We bear in mind that (in the language of economics today) efficiency is a concept that is usually taken to encompass "progress"; and that commonly efficiency is said to encompass allocative efficiency, production efficiency and dynamic efficiency."*

Examples of public benefits that have been recognised by the Commission and the Tribunal in the past include:

- (a) fostering business efficiency, especially when this results in improved international competitiveness;
- (b) industrial rationalisation resulting in more efficient allocation of resources and in lower or contained unit product costs;
- (c) expansion of employment or prevention of unemployment;
- (d) promotion of industry costs savings resulting in contained or lower prices at all levels in the supply chain;
- (e) promotion of competition in industry;
- (f) promotion of equitable dealings in markets;
- (g) economic development, for example development of natural resources by encouraging exploration, research and capital investment;
- (h) assistance to efficient small business, for example guidance on costing and pricing or market of initiatives which promote competitiveness;
- (i) industrial harmony;
- (j) improvement in the quality and safety of goods and services and expansion of consumer choice; and
- (k) supply of better information to consumers and business to permit informed choices in their dealings.<sup>21</sup>

<sup>20</sup> (1994) ATPR 41-357 at 42,677.

<sup>21</sup> ACCC Guide to Authorisations and Notifications at page 20.

In assessing public detriments the primary emphasis should be on those detriments that affect economic efficiency.<sup>22</sup> Detriments which have been previously recognised include:

- (a) a reduction in the number of effective competitors in a market;
- (b) increased restrictions on entry to a market; and
- (c) constraints on competition by market participants affecting their ability to innovate effectively and conduct their affairs efficiently and independently.<sup>23</sup>

As previously submitted, anti-competitiveness does not necessarily equate to detriment.

In *Re Media Council of Australia (No. 2)*<sup>24</sup> it was stated that:

*"It is erroneous to equate anti-competitiveness with detriment. Anti-competitive behaviour may in certain circumstances be a positive benefit."*

Present and likely competition must be assessed within a market structure. In *Re Application by Concrete Carters Association (Victoria)*<sup>25</sup> it was put by the Tribunal as follows:

*"Competition is an active process rather than a passive situation. Nevertheless, the existence and extent of competition or likely competition between those competing with a market will depend, to a large extent, upon the distinctive, albeit evolving structure of that market."*

## 2.7 Counterfactual

As the Commission is aware, in determining whether to grant an authorisation, the Commission must compare the likely shape of the future both with and without the relevant conduct for which authorisation is being sought.<sup>26</sup>

When VENCORP made its application to the Commission in 1997 for authorisation of the MSO Rules, no competitive gas market existed in Victoria. The Victorian gas industry reform proposals were submitted on a greenfields basis with the Code allowing for two broad systems for transportation flow of gas, market carriage or contract carriage, at the election of the pipeline service provider.<sup>27</sup> The prior

<sup>22</sup> ACCC Guide to Authorisations and Notifications at page 20.

<sup>23</sup> ACCC Guide to Authorisations and Notifications at page 23.

<sup>24</sup> (1987) ATPR 48-406 at 48-419.

<sup>25</sup> (1978) 31 FLR 193 at 216.

<sup>26</sup> *Re Tooth & Co Ltd and Tooheys Ltd* (1979) ATPR 40-113 at 18, 186-187

<sup>27</sup> Section 5.7 of the Code.

monopoly supply arrangements did not comprise a “market carriage” or a “contract carriage” system.

It is important to note however, that while the Code offers market carriage or contract carriage systems, there is no unique form of either model.

In considering the 1997 Submission and establishing a counterfactual, the Commission adopted a contextual reference which is similar to that described in the Code and determined that the counterfactual to a market carriage system operating pursuant to the MSO Rules, was a contract carriage system.

By 1 January 2003 the MSO Rules and the market carriage system will have been in place for approximately four years, forming an integral part of the Victorian gas industry. The industry was privatised on this basis, and much of the industry arrangements, both contractual and otherwise, and the existing legal and regulatory framework, are based on the current arrangements, which are founded on a market carriage system.

When the Commission considered the 1997 Submission:

- (a) Victoria did not have open access or a competitive market for the PTS;
- (b) industry contracts or arrangements were not based on market carriage;
- (c) Victorian businesses had not developed their systems and processes to interact with spot market arrangements;
- (d) the Victorian access arrangements relating to the PTS had not been approved on the basis of market carriage;
- (e) full retail competition had not been considered, and the Victorian gas industry had not spent significant time, resources and money on developing full retail competition rules and systems, all of which are based on the continuation of the existing spot market and market carriage arrangements; and
- (f) the Victorian gas market did not have existing multiple sources of gas supply with bi-directional flows of gas between Victoria and other States.

All of these have now occurred or currently exist.

VENCorp submits that, since 1998 the gas market, the gas industry, the legal and regulatory framework and Participants’ systems and processes, have all developed to a point where a complete restructure would be required to accommodate a contract carriage system in Victoria. This would include substantial amendments to the Victorian legislative scheme, re-designing of the Victorian access arrangements relating to the PTS, and significant restructuring by Participants. Such changes would involve substantial costs. It is also important to note that at this time no one has developed or put forward details of any form of alternative system that would be suitable in Victoria given the specific characteristics of the Victorian system and market as detailed in **section 3**.

While there are some critics of the MSO Rules and the Victorian market design, there is widespread support for the market and the MSO Rules, particularly amongst new market entrants and in the retailing sector. There is no widespread support for a complete overhaul and replacement of the market carriage arrangements with contract carriage arrangements, even if such were feasible.

As noted in **section 1.1**, the separation of operation and ownership of the PTS is enshrined in Part 8 of the GIA, the MSO Rules, and supporting contracts. This separation will continue unless amended by statute<sup>28</sup>. While this submission seeks authorisation for the MSO Rules, the Commission's determination will not alter the statutory role of VENCorp as independent system operator, or result in introducing contract carriage on the PTS.

The Victorian Government has indicated that it currently has no intention to legislate the changes to the role of VENCorp that would be necessary to accommodate contract carriage on the PTS. The relevant Minister has expressed strong support for the role of VENCorp in the gas market, and indicated that any review of that role at this time would adversely impact on investment certainty in the industry.<sup>29</sup>

Therefore it is no longer appropriate to consider contract carriage as the counterfactual. Rather, the counterfactual is a different version of market carriage.

As stated above, there is no unique definition of market design for implementation of either "market carriage" or "contract carriage" capacity management regimes. Rather, in each implementation markets are uniquely designed for the specific requirements of the situation to which they are applied. The currently operational market in Victoria has been designed for the PTS' requirements, using market carriage. Significant legal, regulatory and industry procedures have been put in place to support a market carriage system and the public benefits achieved under such system. Any failure to authorise the MSO Rules would most likely lead to the Victorian Government, Participants and other interested parties developing:

- (a) amendments to the MSO Rules to address the Commission's requirements for authorisation; or
- (b) an alternative mechanism to support the on-going operation of a market carriage system.

VENCorp cannot surmise what processes or structures would be put in place to create an alternative mechanism or how an alternative market carriage system would operate. VENCorp submits this in itself highlights that, with the MSO Rules, Victoria has a market carriage system with clearly demonstrated benefits, while without the MSO Rules the future is unclear and uncertain.

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<sup>28</sup> VENCorp notes that section 205 of the *Gas Industry Act 2001* requires a review of Part 8 of the Act, including the role of VENCorp, to be undertaken by 31 December 2007. If that review concluded that fundamental changes were required to the role of VENCorp, the Victorian Government would need to develop and enact statutory amendments to implement any such changes.

<sup>29</sup> As commented by the Hon. Candy Broad MP at the Australian Gas Association's Gas Industry Forum, 26 June 2001.

### **3 VENCORP AND MARKET CARRIAGE IN VICTORIA**

#### **3.1 VENCORP's Role and Functions**

VENCorp was formally established on 11 December 1997 as a statutory, State Government-owned entity and plays a key role in Victoria's predominantly privatised gas and electricity industries.

VENCorp has major operational, planning and development roles for both gas and electricity which are prescribed in State legislation. The key components of these roles are:

- (a) independent system operator for the Victorian gas transmission network;
- (b) administrator and developer of the Victorian wholesale gas market; and
- (c) system planner, providing planning services for the gas and electricity industries, including undertaking the role of transmission network service provider in Victoria in the National Electricity Market.

In addition, VENCORP has operational and communications responsibilities during gas and electricity emergencies, and is currently responsible for facilitating the development, implementation and operation of full retail competition in gas in Victoria.

VENCorp's roles as system operator and administrator of the competitive wholesale gas market are prescribed by the GIA. Functions required to undertake these roles are prescribed by the GIA and the MSO Rules. These functions are funded by Market Participants and the tariffs are regulated by the Commission pursuant to VENCORP's access arrangement and the MSO Rules.

Two important features of the way in which VENCORP fulfils its statutory functions are the governance arrangements, and consultative processes detailed below:

##### **(a) VENCORP Governance**

VENCorp is a statutory authority, governed by an independent Board of Directors, and funded by industry on a cost recovery basis. Accordingly, VENCORP ensures that it meets its statutory and stakeholder obligations as efficiently and economically as possible.

The structure of VENCORP's board of directors is set out in sections 165 and 166 of the GIA. The State Government nominates all Board members. The Board has an independent chairperson and not more than 9 other directors, at least 3 of whom are independent. Industry is also represented on the Board (through 4 members from industry backgrounds), such that:

- any industry concerns can be easily raised via the Board members; and
- industry representative directors are well placed to scrutinise VENCORP's operations and costs.



**(b) Gas Market Consultative Committee**

The rule change process is prescribed in the MSO Rules and allows any person or organisation to propose changes to the MSO Rules, and requires VENCORP to consult with all affected parties prior to reaching a decision on change proposals<sup>30</sup>.

In fulfilling these obligations, VENCORP consults broadly on all major market design/development issues. The VENCORP Board has established an industry representative committee, the Gas Market Consultative Committee (“**GMCC**”) as the peak industry consultative forum on wholesale gas market issues and the MSO Rules. The GMCC has a formal constitution that governs its membership and operating procedures, including voting rights and protocols.

Since it was established in 1998, the GMCC membership has changed to reflect the evolution of the market from development phase to its present commercial operating status, and representation is reviewed regularly to ensure that it remains commensurate with the sectoral interests in the gas market.<sup>31</sup>

The main functions of the GMCC are to:

- consider and make submissions to the VENCORP Board in relation to development of the gas market to improve the market’s efficiency and effectiveness;
- provide a forum for Participant consultation and involvement in determining issues relating to the operation or functionality of the gas market as required by the MSO Rules; and
- make recommendations to the VENCORP Board regarding desired or proposed amendments to the MSO Rules.

The GMCC has proved to be a very effective forum to deliver these functions. In 2001, VENCORP undertook a public review of its consultation processes. That review concluded that there was a high level of satisfaction with current processes, and that no significant changes were required.

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<sup>30</sup> Clauses 8.1(a) and 8.2 of the MSO Rules.

<sup>31</sup> At present, the GMCC comprises a VENCORP chairperson, 3 representatives of (incumbent) retailers, 1 representative of a new entrant retailer, 1 representative of the transmission pipeline owner, 1 representative of gas distributors, 2 representatives of producers and gas storage operators, 1 representative of market customers, 1 VENCORP operational representative, 1 VENCORP market representative and 1 non-voting secretary.

## **3.2 Rationale for Applying Market Carriage to Victoria**

The Victorian gas spot market arrangements are designed to enable a market-driven operation of the PTS.

The arrangements are a package that is carefully designed to match the physical requirements of the PTS, and are based on the significant structural, commercial and competitive reforms undertaken in Victoria. The market carriage arrangements are an essential component of this package, designed to maximise the benefits from these economic and competitive reforms.

VENCorp has elected market carriage as its capacity management policy in its access arrangements under the Code.

The wholesale gas spot market and the MSO Rules implement a particular version of market carriage that is both applicable, efficient and competitive in the Victorian context.

An appreciation of the characteristics of the PTS is helpful in understanding some of the features of the gas spot market, and why Victoria has different needs from other States.

### **3.2.1 Structural Reforms**

The Victorian Government implemented the following significant structural reforms in the downstream gas and transportation sectors in Victoria for the purposes of promoting competition and economic development in the State:

- (a) Asset ownership was fully divested to private enterprise, and ring fencing of retail and asset ownership businesses was implemented.
- (b) The previously Government-owned retailing function has been fully divested to private enterprise.
- (c) The retailing sector was structurally reformed to instil inherent initial competition between 4 participants, with arrangements made to facilitate entry by new retailers.
- (d) Victoria has implemented retail competition down to the 5TJ level, and on 1 October all customers will be fully contestable.

The Victorian context is therefore one of competition encompassing full deregulation, full privatisation, and full retail competition.

### **3.2.2 Facilitating Full Retail Competition**

The current Victorian version of market carriage is specifically designed to facilitate the implementation of full retail competition by providing efficient arrangements for balancing the system, and facilitating retailing competition by providing options other than being forced into long term supply and transportation contracts in the face of a

contestable customer base. A full discussion of these benefits is provided in **section 6** of this submission.

### **3.2.3 *Independent System Operator***

As a part of its structural reforms in the Victorian industry, including the implementation of a transparent and competitive spot market for managing system operation and financial trading, the Victorian Government determined that the most appropriate way forward was to create an independent market and system operator.

The Government vested VENCorp with the statutory role to operate the gas transmission network (separating ownership of the transmission assets into a separate company<sup>32</sup>) and with the role of administering the market by which this system operation is managed.

### **3.2.4 *Physical Requirements of the Victorian Transmission Network***

The gas transmission system in Victoria is a network of interconnected high pressure transmission pipelines, operating as a "meshed" network with multiple points of supply and over 100 withdrawal points.

Each day, gas is offered into the Victorian system from each of at least four different supply sources (Longford, underground storage, liquified natural gas ("LNG") and via the NSW interconnect at Culcairn), with multiple parties offering gas supplies at each of those sources. Within 2 years, 3 additional sources are expected to be supplying gas into or from the Victorian transmission network (connections expected at Iona, Pakenham, and Longford).

Gas flows on substantial sections of transmission pipelines in the Victorian system have the potential to be bi-directional on any day, dependent on market and demand conditions at the time. This is especially relevant on the South West Pipeline, for gas transportation to or from the underground storage, and potentially connection to South Australia.

The arrangements in other States in Australia for gas transmission relate to single, long distance "point-to-point" transmission pipelines. The distinguishing feature of these arrangements is that they exhibit a predominantly uni-directional flow that enables the management of pipeline capacity to be along "contract paths", which is very different to the needs of a transmission network such as the PTS.

Importantly, the Victorian gas demand profile is quite different from other States. Victoria has the largest domestic gas market in Australia. The significantly higher proportion of domestic gas demand (greater than 40% of the total market) makes the Victorian system demand highly sensitive to weather and inherently more difficult to forecast on a day to day basis. In winter, the demand can vary between about 700TJ and over 1100TJ from one day to the next.

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<sup>32</sup> Being Transmission Pipelines Australia Pty Ltd (now known as GasNet).

In other States, swings in demand, and variations from within day forecasts, can typically be managed by utilising linepack in the transporting pipeline, with sufficient scope to allow for inter day borrowing and balancing, and monthly resolution. In Victoria, however, this is simply not a viable option, and never has been.

Typically, basin producers are compelled by both technical realities and commercial circumstances to inject natural gas in a reasonably flat profile throughout the day. In Victoria, consumers are able to consume gas whenever they want during the day (and do). Typically, the transmission pipeline operator will manage the basis risk arising within a day from this profile difference between the supply and consumption patterns, by using the capability of the systems to hold linepack to manage the swings. This is a particularly relevant issue in Victoria, due to the high penetration of gas into the domestic heating market, with this component of the total system gas demand very sensitive to temperature<sup>33</sup>. In light of a flat supply profile, the transportation requirements need very careful management to ensure that pressures are maintained at satisfactory levels during the day.

The total linepack in the Victorian transmission network varies between about 450TJ and 600TJ over each day as the system demand is satisfied. On peak days, over 1100 TJ is shipped through the transmission network, or approximately twice the entire linepack in the transmission system. The design of the system requires linepack to supply the diurnal swing in demand, and under peak conditions, this results in the absolute minimum operating pressure being reached at some locations in order to deliver the daily demand. This supply is transported from several different sources to the customer load centres. By way of comparison, the peak demand on the Moomba pipeline is approximately 25% of the pipeline volume transported each day, the flows are predominantly uni-directional, and the total load has a much flatter profile and better capacity factor.

In Victoria, each day the total linepack must be returned to approximately the same level, to ensure that there is sufficient scope for managing the diurnal swing. There is very little leeway on this during winter. Although the capacity of the system is large, it is effectively already fully utilised to manage the inherent profile divergences, and the physical requirements are therefore that the system must be maintained in balance each day. Therefore, there is little scope to offer park and loan schemes and daily and intra-day balancing is critical on the Victorian network.

Unlike on many other transmission pipelines, it is often necessary in Victoria to reschedule gas injections or withdrawals more than once a day in order to re-balance the transmission network to manage deviations from forecast demand for gas. The management of hourly imbalances throughout the day becomes critical in light of the limited linepack and uncertainty in weather driven demand. It is likely that the fine balance between supply and demand will always remain. There will always be a tension between meeting growing demand and providing more capacity by adding additional looping or compression to the system. This issue will become even more

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<sup>33</sup> For example, a rule of thumb is that a 1 degree difference in maximum daily temperature can result in a change in the total system demand by approximately 40TJ during peak winter periods (refer VENCorp Annual Gas Planning Review, Nov 2001 at page 80).

critical, especially in the advent of more peaking gas fired power generation connecting to the system.

#### 4 1998 DETERMINATION - PUBLIC BENEFITS AND POTENTIAL DETRIMENTS ARISING FROM MSO RULES

In granting the Current Authorisation the Commission recognised the MSO Rules as being part of a series of structural reforms to the Victorian gas industry that were intended to increase efficiency in gas wholesale trading and transmission. These arrangements were considered to be likely to have efficiency benefits in terms of better utilisation of infrastructure and capital, and to give rise to benefits from transparent and uniform treatment of wholesale Participants. Specifically the Commission noted:

*"As most trading in the short term is likely to be via contracts, the Commission is of a view that the gains in the short term are likely to arise from efficiencies in access pricing and access to transmission and distribution pipelines on a non-discriminatory basis, facilitating, in the longer term, upstream and downstream competition. In the longer term, the gains from the development of competitive wholesale trading of gas are likely to be more substantial as new sources of supply emerge.*

*The Commission recognises that competition may evolve over time if the MSO Rules was not implemented, but believes that the MSO Rules will initiate and accelerate the benefits of competition."<sup>34</sup>*

In its 1998 Determination the Commission found the expected public benefits from the MSO Rules could be summarised as:

- (a) the promotion of economic efficiency from structural reform, and the introduction of wholesale competition by the development of spot sales;
- (b) an increase in customer choice arising from the unbundling of gas supply from distribution and transmission;
- (c) possible environmental benefits;
- (d) general benefits to the Victorian economy by improved network services; and
- (e) even though the MSO Rules do not directly incorporate the retail sector, the market carriage model will facilitate retail competition and aid in passing through the benefits of reform and competition. It may also act to provide some of the conditions necessary for upstream competitions.<sup>35</sup>

VENCorp submits these public benefits have in general been achieved as have additional public benefits, as described in **section 6**.

<sup>34</sup> 1998 Determination at page 159.

<sup>35</sup> Section 4 of the 1998 Determination as summarised at pages 159-160.

The Commission noted concerns of the potential for a number of public detriments. These concerns were summarised as:

- (a) possible market distortions arising from the design features of the MSO Rules – single zone daily pricing necessitating the need for ancillary and uplift payments, price caps and force majeure provisions;
- (b) insufficient accountability and transparency in the arrangements; and
- (c) potential for tacit collusion arising from the information disclosure provisions of the MSO Rules in a market with a limited number of players<sup>36</sup>.

VENCorp submits these potential detriments have not eventuated, as more particularly described in **section 7**.

Other Commission concerns were dealt with through the conditions the Commission imposed in granting the authorisation.

The Commission also recognised that it was expected that the MSO Rules would be regarded as imperfect, given it was the first attempt to create wholesale trading arrangements and an access regime for transmission of gas. The Commission anticipated that further deficiencies might emerge once the MSO Rules had been implemented, but the Commission's view was that these could be addressed through the MSO Rules change process<sup>37</sup>.

As the Commission is aware, VENCORP has made a number of applications<sup>38</sup> for minor variations to the Current Authorisation amending the MSO Rules and refining how the MSO Rules operate. Each of these applications was accepted by the Commission with few submissions from Participants. VENCORP submits this demonstrates how the rule change process in Chapter 8 of the MSO Rules provides an effective forum for consultation, and addresses Participant concerns and interests prior to any formal application for variation.

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<sup>36</sup> Section 4 of the 1998 Determination as summarised at page 60.

<sup>37</sup> 1998 Determination at page 160.

<sup>38</sup> VENCORP has made 13 applications for variation of the authorisation, which have all been approved by the Commission (in some cases rolling several applications into one determination).

## **5 MSO RULES – SYSTEMS AND PROCESSES**

The MSO Rules relate to and govern conduct in a proven, operating, competitive wholesale market for gas in Victoria. The MSO Rules provide a uniform framework in which all Participants may operate and allow VENCorp to function as an independent system operator making transparent decisions.

In order to provide a context for consideration of the public benefits and potential detriments of the MSO Rules, it is first useful to categorise the MSO Rules systems and processes against functions that need to be performed and paid for under any open access system. Some of these are essential, and some are optional but desirable.

The table on the next page describes these functions.



Function required under competitive open access system	Systems and Processes established under the MSO Rules
<b>Essential Functions</b>	
Gather all information needed for efficient and reliable pipeline operations	Registration ( 2)  Market Operation and Administration – (Gas Scheduling, Nominations and Bidding process) (3)  Technical Matters (4)
Determine how the system operates	Gas Scheduling ( 3.1)  Intervention, Emergencies ( 6)
Issue and enforce scheduling and dispatch instructions	Gas Scheduling process Ch (3.1)
Manage Metering Information, Settlements and prudential risk	Metering (4.4)  Allocation and Reconciliation (3.5)  Settlement of the Wholesale Market (3.6)  Prudential Requirements (3.7)
Provide gas balancing service	Automatic low cost balancing service provided through Market Operation and Administration (3)
System Security and Reliability	Intervention and Market Suspension ( 6)
<b>Desirable Functions</b>	
Produce reference price used for contracting and risk management activities	Setting of wholesale gas spot market price ( 3.2)
Market Information to assist participants in operation and investment planning	Market Information and System Planning (5)
Consultation/decision making process for evolving market arrangements	Rule change process (8)
Dispute resolution	Dispute Resolution process (7.2)

Numbers in brackets refer to Chapter or clause of the MSO Rules

## **6 PUBLIC BENEFITS RESULTING FROM MSO RULES**

VENCorp submits that the public benefits expected when the Commission gave the 1998 Determination have been achieved. VENCorp further submits that there have been further public benefits arising from the MSO Rules and that continued authorisation of the MSO Rules will allow the existing public benefits to continue and for further anticipated public benefits to eventuate.

The key benefits are discussed below.

### **6.1 Facilitating Wholesale Competition**

The wholesale gas market is a competitive market between buyers and sellers<sup>39</sup>. A competitive wholesale market is likely to be characterised by an increased number of actual or potential sellers and buyers such that there are incentives to set prices efficiently, for costs to be minimised, and for services to be provided at a level of quality demanded by customers.

In granting the Current Authorisation the Commission noted:

*The MSO Rules also act to provide some of the conditions necessary for upstream competition.<sup>40</sup>*

In general VENCorp submits that the MSO Rules provide for a competitive wholesale market, and facilitate open access to the Victorian network and network services, interstate trade, retail competition and contestability. This, in turn, facilitates development of upstream competition.

In considering how the MSO Rules contribute to competition, it is useful to consider the following aspects of the wholesale market:

- (a) Market timeframes and efficient operation of the transmission network (short run).
- (b) Efficient development of the gas market (medium and long run).
- (c) Promotion of price discovery and transparency.
- (d) Facilitation of interstate trade.
- (e) Openness and transparency of MSO Rules.

These elements are discussed below.

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<sup>39</sup> Retailers, traders and underground gas storage providers can be buyers or sellers. Large customers including gas fired electricity generators are buyers and gas producers may be sellers.

<sup>40</sup> Section 4 of the 1998 Determination as summarised at pages 159-160.

### **6.1.2    *Efficient Operation of the Transmission Network and Market***

The nomination, scheduling and settlement processes established by the MSO Rules provide a flexible market-oriented system by which many different buyers and sellers have maximum freedom to adjust their activities to meet their own needs and requirements, while solving the complex economics of the network as well as ensuring safe and secure pipeline operations.

The spot market provides a mechanism by which Market Participants can trade, and thus influence, the value of gas at different points around the system at different times.

VENCorp submits that the anticipated public benefits of efficient operation of the transmission network and market have been achieved and are expected to continue in the future. Notably:

- (a)     market operation has operated successfully under extreme conditions without the need for intervention by VENCorp (refer to **section 7.1.2** for more information);
- (b)     there is some evidence of demand response, from spike loads, at times of high prices;
- (c)     transmission pipeline constraints have been effectively managed, and improved management of constraints is expected in the future; and
- (d)     the costs of operating the market (covering all the functions required to operate any open access pipeline system) are reasonable, prudent and efficient (refer to **section 7.5** for more information).

#### **(a)     *Experience with Market Operation***

To date, the MSO Rules have provided an efficient and cost effective way of managing both system operation and a market for gas imbalances, whilst managing the capacity of the PTS such that system security has been maintained.

The costs for such have fallen in real terms, and are expected to fall by over 10% over the next 5 years.

New Market Participants have entered the market and are competing for market share and customers. New sources of supply have connected and more are planned. Transmission constraints have been minimal, with minimal associated costs. New gas-fired generation is being facilitated, with several new plants on line and more planned in the near future.

Each day Participants submit bids for injection of gas, and this determines the price of gas imbalances in a competitive manner which is simple to use and manage. The market price has been shown to react in an expected manner when demand exceeded the reported levels of contracted maximum daily quantity under the gas sales agreement between GASCOR and Esso/BHP ("**Gas Sales Agreement**").

The market systems have been demonstrated to be robust, efficient and very effective, particularly with definition of the requirements for the daily/hourly operation of the system. There has been constant monitoring and surveillance by VENCorp and Participants with no evidence of any anti-competitive behaviour. Information provision by the market is acknowledged as a critical requirement for efficiency and investment.

Experience has shown that the market has reacted flexibly to changes in the demand and supply balance, even at times of severe stress. The effectiveness of the MSO Rules in arriving at market-based solutions has resulted in a market driven approach to operation of the network which is both efficient and has avoided the need for any intervention by VENCorp<sup>41</sup> since the market commenced over 3 years ago.

For example, the General Manager Trading of TXU Trading noted the following after a period of very high gas demand in May 2000:

*"We were very pleased to observe VENCorp's professional approach during these days, in particular by permitting the market to operate in these tight conditions without intervention. We were also pleased that VENCorp's staff maintained regular, courteous communications with our traders throughout the period within the limits of systems and the market rules.*

*The MSOR enabled the Victorian gas system to achieve a number of firsts:*

- *The spot price of gas increased on the day to reflect tightening of the supply/ demand balance.*
- *Participants made economic decisions regarding the value of the LNG stocks, allowing them to be bought by others. This is in stark contrast to the LNG conservation approach of the past.*

*TXU customer demand could be adjusted in response to price information, enabling TXU overall demand to be reduced. We note that VENCorp market re-forecast was a key factor in enabling this to occur."*<sup>42</sup>

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<sup>41</sup> The matter of intervention is detailed further in **section 7.1.2**.

<sup>42</sup> Letter from Mr Len Gill, General Manager Trading of TXU Trading, to Mr Matt Zema, Chief Executive Officer, VENCorp, dated 7 June 2000.

**(b) Management of Pipeline Capacity**

In an article in the Australian Gas Journal in June 2000, Mr Max Kimber commented that:

- “The (National Access) Code does not acknowledge that capacity constraints should provide price signals.”
- “The secondary market for pipeline capacity is not well developed in Australia.”
- “The Code does not recognise the increasing volatility of the energy market, where shippers now demand contracts for firm service for periods as short as one year.”
- “There is little evidence of creative or innovative processes from either the service providers or the regulators which might provide a market based response to these constraints.”

These comments apparently overlooked the design, development and operation of the market carriage arrangements in Victoria, which recognised all these issues and specifically sought to provide appropriate market based mechanisms to deal with them.

This was acknowledged by Dr David Whitelaw of GasNet in the September 2000 edition of the Australian Gas Journal where, in an article responding to the article by Mr Kimber, Dr Whitelaw stated that:

- “the Victorian Market Carriage model does provide a framework for such price signals to eventuate”;
- “the appropriate mechanism for valuing capacity is the Authorised Maximum Daily Quantity (AMDQ)<sup>43</sup> which plays the role of a capacity right in the Victorian market, albeit primarily a financial rather than physical right”; and
- “GasNet is supporting this development and looks forward to the day when all AMDQ is synonymous with well defined, tradeable capacity rights”.

Since the publication of that article, AMDQ rights have become tradeable in the Victorian gas market. Nevertheless, VENCorp considers that the AMDQ concept and the way in which the cost of managing constraints are allocated still requires further development, and is currently reviewing this through its consultative processes. This innovation will provide appropriate market based pricing signals and facilitate the development of effective secondary trading markets.

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<sup>43</sup> Meaning in respect of a customer, the maximum quantity of gas authorised by VENCorp to be withdrawn by or on behalf of that customer.

**(c) Costs of Market Operation**

The MSO Rules provide an efficient and low cost method of managing system operation via an integrated spot market. The cost for VENCORP to provide all the systems and processes outlined in the table in **section 5** are equivalent to around 1% to 2% of the delivered price of gas for customers.

VENCORP submits that this level of cost is very reasonable considering that all of its functions are essential to the operation of any competitive open access system.<sup>44</sup> Refer to **section 7.5** for further details.

**6.1.3 Efficient Medium and Long Term Development of the Gas Market**

In the medium to long term, Participants in the gas market are expected to make their own decisions on gas production and consumption, including decisions on new investment. The MSO Rules only have an indirect impact on these medium to long-term decisions in that they impact on how Participants anticipate that nomination, scheduling and gas balancing will be managed, and how access to the available transmission capacity will be managed.

The pricing and terms of the existing Gas Sales Agreement will dominate the gas market in Victoria for some time to come. This reflects the terms of the agreements entered into and the substantial existing investments that have been made by ESSO/BHP.

As discussed above, the Commission in granting the Current Authorisation anticipated that there would be gains from the development of competitive wholesale trading of gas as new sources of supply emerge.

Since the 1998 Determination, there has been a range of developments as follows:

**(a) Completed infrastructure developments:**

- The capacity of the interconnect with NSW has been expanded.
- The South West Pipeline has been constructed to connect the PTS with the Otway Basin.
- The Eastern Gas Pipeline (Longford to Sydney).
- The Western Underground Storage facility has also been completed and commissioned.

**(b) New pipeline developments that have, or are about to be, commenced:**

- The Longford- Bell Bay (Tasmania) pipeline and Vichub.

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<sup>44</sup> Refer to Dr L.E. Ruff's comments set out in **section 7.5**.

- The SEAGas pipeline from the Otway Basin to South Australia.
  - Connection of Yolla gas fields to the PTS.
- (c) A number of other potential sources of gas supply at various stages of development include:
- Patricia Balleen in the Gippsland basin with contracted supplies of 60PJ from late 2002;
  - Minerva/Thylacine gas fields (expected to be developed in association with the development of the SEAGas pipeline from the Otway basin to South Australia);
  - Yolla gas fields (expected to be available in 2004); and
  - Kipper gas field (expected start up within the next 5 years).

VENCorp considers the level of gas supply and pipeline developments in Victoria and in the adjacent markets since the commencement of the Victorian spot market under the MSO Rules, has been very healthy and are fully consistent with the expectations of the Commission at the time the Current Authorisation was granted.

It is recognised that not all of these developments fall under the operation of the MSO Rules, nor have they all adopted similar operational or trading arrangements. However, this is not considered important or particularly relevant. They all do, or will, interface with the PTS and, hence, the MSO Rules in some way.

Mr Grant King, Managing Director of Origin Energy Ltd was reported as saying:

*"Until deregulation in the 1990s, energy infrastructure was limited and markets were heavily regulated and there was no incentive for people to explore for gas in eastern Australia - as long term contracts were locked up for 25 to 30 years. But the opening up of markets has since stimulated Australian gas exploration with a number of resources waiting to come on line."<sup>45</sup>*

These developments and potential developments have, and will, assist to reduce Victoria's dependence on supplies from Longford and assist in further developing a competitive and integrated market for gas in South-East Australia. VENCorp submits these developments have been facilitated by the introduction of the competitive industry reforms and provisions for open access, of which the MSO Rules forms an integrated part, and either have or will contribute to increased competition in the Victorian wholesale gas market.

<sup>45</sup> Speech by Mr Grant King to a business breakfast in April 2002.

#### **6.1.4 Promotion of Price Discovery**

Competitive markets achieve efficiency in allocation of resources. Allocative efficiency in markets is promoted through price discovery. Discoverability of price relates to transparency of the price setting process and the ability to model outcomes so as to undertake appropriate decisions. Additionally, in competitive markets, forward markets develop which enable buyers and sellers to enter into forward contracts to manage their risk, and reference prices emerge that can be used for contracting and risk management activities.

The MSO Rules promote complete transparency in the wholesale spot market price thereby leading to more effective decision making by businesses (not just restricted to Participants) in relation to other markets (interstate gas or electricity) and contracting. It should be noted that much of the commercial hedging and financial activity that may develop in the future will be confidential, but may use the spot market price as a reference in contracting.

Participants are supportive of this approach. For example:

Edison Mission Energy state:

*"From an end user's perspective the Victorian Gas market is the most transparent and efficient gas market in operation in Australia today."<sup>46</sup>*

TXU Australia recently noted:

*"The Victorian spot market currently provides access to gas volume. The market has low barriers to entry and good price transparency."<sup>47</sup>*

VENCorp submits that public benefits arise because the wholesale gas spot market price produced as part of the daily operation of the gas market contributes to the promotion of price discovery both within the Victorian gas market, and in other related markets.

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<sup>46</sup> Edison Mission Energy submission to COAG Energy Market Review, April 2002.

<sup>47</sup> Speech by Manager Trading, Mr Andrew Brown to the VicGas 2001 Conference in October 2001.



### **6.1.5 Facilitation of Interstate Trade**

The 1998 Determination raised concerns regarding the compatibility of trading arrangements between States.<sup>48</sup>

VENCorp submits that :

- (a) evidence of interstate trade across the Victoria–NSW interconnect at Culcairn indicates that the differences in the models in each state, and specifically the MSO Rules, do not represent any substantive barrier to trade;
- (b) perceptions of contracting difficulties in dealing with a market carriage system are misplaced; and
- (c) the MSO Rules appear to promote interstate trade given there is no requirement for retailers to book or acquire capacity on the PTS.

#### **(a) Evidence of Interstate Trade**

Arrangements for interstate trade were initially limited to make allowance for the requirements of the Australian Pipelines Trust (“APT”) system for confirming orders before the start of the day for shipping gas. Today, however, arrangements for shipping gas between the States are flexible and price responsive.

Each day, several retailers submit bids<sup>49</sup> in Victoria for quantities of gas for injection into the PTS or exports to NSW over the interconnect. The bids are all price related, and actual flows scheduled for the interconnect (imports and exports) are determined by the market clearing price.

**Figure 6.1** depicts net daily flows across the Victoria–NSW interconnect at Culcairn. Flows take place in both north and south directions and involve multiple parties. The graph shows only actual net flows, with flows in both directions often being nominated or scheduled on the same day. The nominal flows in either direction have historically often approached and even exceeded the firm capacity, which is 17TJ/day for exports<sup>50</sup> (flows from Victoria to NSW), and typically 50 TJ/day<sup>51</sup> for imports (from NSW to Victoria).

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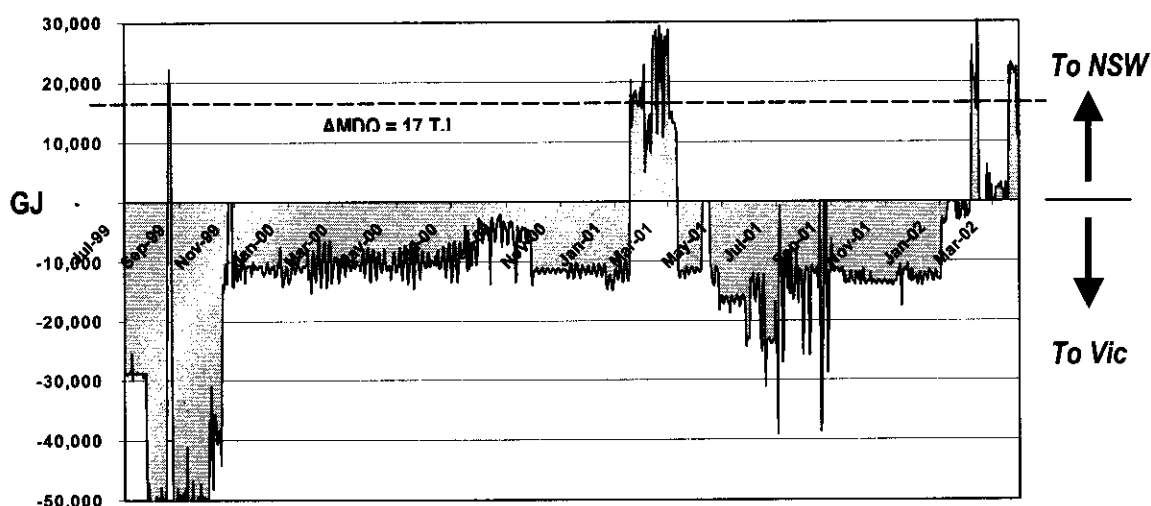
<sup>48</sup> 1998 Determination at page 30.

<sup>49</sup> At present, typically 22TJ is being bid for exports to NSW, and 14TJ is being offered for import to Victoria – details can be obtained from the bid information which is published by VENCorp on its website.

<sup>50</sup> 17TJ of AMDQ has been assigned to the interconnect for exports, representing the firm capability of the facility. At times export up to 25-28TJ/day is possible. Typically about 20-22TJ/day is being exported each day at present.

<sup>51</sup> 35TJ/day uncompressed, 50TJ/day with Springhurst, and potentially up to 92TJ/day with Young compression and favourable operating conditions in the APT system – Refer VENCorp Annual Gas Planning Review 2002-2006, Nov 2001 at page 31.

**Figure 6.1. Net (physical) flows over the interconnect**



These actual market outcomes illustrate that the difference between the market arrangements in Victoria and NSW is not presenting a material barrier to trade.

An independent report by ABARE<sup>52</sup>, commissioned in 2000 by the inter-jurisdictional Energy Policy Group, also confirmed that the differences in the market models in each State do not represent any substantive barrier to trade.

The AGA stated recently that:

*"... The wholesale market represents a small percentage of delivered gas prices and wholesale prices closely reflect existing contractual arrangements with gas producers.*

*"The AGA is not aware that the different wholesale market approaches adopted in New South Wales and Victoria represent a significant impediment to competitive or sustainable wholesale energy markets.*

*"Wholesale market arrangements are limited in Australia by the absence of vigorous upstream competition"<sup>53</sup>*

In its submission to the COAG Energy Market Review, the National Retailers Forum<sup>54</sup> concluded that inter-basin competition was primarily driven by upstream and transportation costs, rather than market design:

<sup>52</sup> Harman J & Roberts A: "Gas Pipeline Management – Contract and Market Carriage Regimes", ABARE Report to DISR, July 2001.

<sup>53</sup> Australian Gas Association submission to the COAG Energy Market Review, April 2002.

<sup>54</sup> NRF Submission to COAG Energy Market Review, Part B Gas Wholesale Market Reform Issues, 19 April 2002, page 24.

*"Inter-basin competition is economically possible in all major markets. However, based on the above it is clear that:*

- *inter-basin competition may limit the number of competitors to just two, eg in Melbourne;*
- *intra-basin competition, such as is possible with the development of the Kipper or other fields in the Gippsland Basin, is also critical;*
- *pipeline costs have a major impact on the upstream competition."*

In summary, there are significant impediments to interstate trade which exist nationally. These impediments are not a factor of the market arrangements, but rather relate to a lack of upstream competition, and the level of transmission tariffs. The MSO Rules have interfaced effectively with other systems in Victoria and at the NSW-Victorian border, and have therefore facilitated interstate trade.

**(b) Contracting Issues Between the Victorian PTS and the APT System**

It is sometimes argued that contracting issues between pipelines create a barrier to interstate trade.

Contracting issues arise for all interconnected systems, where different physical and contracting arrangements apply. Even if a contract carriage regime of some sort was capable of being introduced on the Victorian PTS, or a market carriage system was introduced for the APT system in NSW, the physical characteristics of the Victorian system would mean that the balancing and contractual arrangements would necessarily be different to those currently employed on the APT system.

Scheduling and settlement of interconnect flows are facilitated by a balancing agreement negotiated between VENCorp and APT, which is similar to balancing arrangements commonly found around the world to manage gas flows between interconnecting pipeline systems. To date no disputes have arisen through the operation of this agreement, and it has enabled sufficient gas flows north to meet the NSW market requirements. Volumes traded are constrained not by different systems, but by the interconnect capacity, transmission tariffs and access to gas.

In addition, it should be noted that there are considerable differences between the arrangements for gas transport for contract carriage pipelines. For example, while Epic's Moomba-Adelaide pipeline and Duke's Eastern Gas Pipelines are both classified as contract carriage but there are both similarities and different approaches between them for transport and balancing.

It is therefore incorrect to argue that such issues arise exclusively because of the MSO Rules or the application of market carriage in Victoria.

**(c) No Requirement for Acquiring Capacity**

The market carriage model does not require the booking or acquisition of capacity. In relation to interstate trade, this means that:

- for gas flowing into the PTS, once gas is transported to the point of interconnection, it is easily transported through the Victorian transmission system. Management of gas transmission constraints (and costs) is achieved through the establishment of AMDQ rights. AMDQ rights provide protection from uplift charges to the holder of AMDQ rights;
- for gas flowing out of the PTS, once gas is transported to the point of interconnection, it can be transported through the connecting transmission system subject to the terms and conditions of access on that pipeline.

During the process leading to the 1998 Determination, concerns were raised in relation to shippers flowing gas North over the interconnect being exposed to uplift charges if the system were constrained. Since then, 17 TJ of AMDQ (which matched the physical capacity of the interconnect) was allocated to the interconnect to cover uplift exposure of North flows. Also refer to **section 7.1.1** with regard to the low levels of uplift charges.

#### **6.1.6 Openness and Transparency of MSO Rules**

Efficient and competitive markets are facilitated by market participants having access to a wide range of accurate and timely information, and having confidence in the market arrangements.

VENCorp submits that public benefits arise due to:

- (a) information being made available on an equitable basis;
- (b) provision of information facilitating investment and business decisions;
- (c) effective consultation and education; and
- (d) effective processes for updating the rules.

These features of the market increase the efficiency with which each Participant makes its decisions, increases confidence of participants, reduces the perceived and actual level of risk, reduces the barriers for entry for new entrants, and increases competition in and around the market.

#### **(a) Competitive Equity Through Information Availability and Transparency of Arrangements**

Efficient and competitive markets are facilitated by all Participants gaining access to information on an equitable basis. This provides greater certainty and assurance to the businesses operating within the market that outcomes are competitive, offering no anti-competitive privileges to any entity.

VENCorp submits that the MSO Rules and VENCorp's administration of the MSO Rules, provide a high level of accurate, timely information on an equitable basis to all Participants which facilitates competition.<sup>55</sup>

Each day, VENCorp publishes a wide range of information on the market and system operation. This information includes schedules and forecasts of price as well as information on actual market outcomes and Participant bids. This information is made available to all Participants. Market information is made publicly available on the web, and through a range of other VENCorp publications including the Gas Market Report, and the Victorian Energy Update.

**(b) *Provision of Information Facilitating Investment and Business Decisions***

Efficient and competitive markets are facilitated where participants have information available to them at low cost to understand future patterns of demand and supply and the potential opportunities to undertake investment.

This is particularly important where the information necessary to undertake evaluation and planning would otherwise be costly to collect.

The MSO Rules (clause 5.2.1) require VENCorp to prepare an Annual Planning Review that is effectively a "statement of opportunities" for the future development of the PTS, gas storage facilities and gas supplies within the Victorian gas market.

The planning information is provided for the primary purpose of allowing Participants to make informed decisions relating to:

- planning for capital investments;
- developing market strategies;
- system maintenance;
- gas storage;
- pipeline operation; and
- market pricing strategies.

The MSO Rules therefore provide an extensive range of detailed technical and market information to Participants based on VENCorp's detailed knowledge of the Victorian gas market.

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<sup>55</sup> As supported by Mr Paul Hyslop of Edison Mission Energy – refer section 7.6.3.

VENCorp submits that the availability of this information substantially reduces the barriers of entry for potential and actual new entrants to the Victorian gas market.

**(c) *Effective Consultation and Education***

Efficient and competitive markets are facilitated where information is available that enables Participants, businesses and the public, to make informed decisions.

Accordingly,;

- information must meet the needs of the Participants (i.e. be accurate, meaningful, and provided on a timely basis); and
- Participants need an appropriate level of understanding as to the purpose and meaning of the information that is provided.

VENCorp submits that the MSO Rules provide for effective consultation and education of industry, Participants and the public.

**(d) *Process for Updating the Rules***

Efficient and competitive markets are facilitated where the process for updating the rules which govern the operation of the system and the market:

- is clear and transparent;
- does not give rise to anti-competitive restrictions/outcomes; and
- is fair, reaching an equitable balance between the interests of all parties whilst delivering the optimal result overall.

VENCorp submits that the rule change processes (chapter 8 of the MSO Rules) and VENCorp's administration of these are fully consistent with these principles.

## **6.2 Efficient Use of Resources**

VENCorp submits the MSO Rules achieve public benefits by promoting the efficient use of resources. There are two categories of economic resources that should be considered:

- (a) utilisation of gas production and consumption resources; and
- (b) utilisation of the PTS.

In relation to the efficient utilisation of resources invested in gas production and consumption, VENCorp submits that the spot market created and operated under the MSO Rules has seen Participants effectively selling their contracted gas, from various sources, to other Participants at the spot price determined through the MSO Rules.

Thus, based on market pricing signals, businesses have decided that it is more efficient for them to buy or sell gas from or to other Participants, rather than simply using contracted gas from suppliers exclusively to meet their own customers' requirements.

Participants are seeking to establish more flexible supplies of gas, from both existing and new sources, to enable them to respond more efficiently to changes in the supply/ demand balance from day to day, and particularly within the daily trading spot market cycle. For example, gas for imports and exports over the interconnect is bid daily on a price basis, arrangements are being made for the development of fast response gas from underground storage, and VENCORP is aware of arrangements in place for a range of other sources of flexible and responsive gas supplies.

In relation to efficient utilisation of the PTS, VENCORP submits that the MSO Rules have facilitated system optimisation on the PTS with efficient use of the PTS based on overall outcomes, maximising system efficiency in both an allocative and productive sense, rather than maximising the position of any one party. These efficiencies result in lower costs for retailers and shippers, ultimately benefitting end users.

### **6.3 System Security and Reliability**

One important public benefit consideration is effective and efficient system security and reliability for an essential service.

It is a primary responsibility of any transmission system operator (irrespective of the form of the market that system may service) to ensure the security of the transmission system and delivery of gas under its control. The transmission operator can achieve this through:

- (a) the incentives established through the normal operation of the market (nomination, and scheduling arrangements); and
- (b) where these are insufficient to counter any threat that may arise to the transmission system, it may implement intervention strategies underpinned by regulation or contractual agreement binding on both the operator and user. Examples of intervention strategies include operational flow orders provided to gas producers and curtailment imposed on gas consumers.

Public benefits are created where the design of the market minimises the need for intervention and maximises the extent to which market participants are able to respond voluntarily (for example, voluntary reduction of demand or increase supply following an unexpected event). This is consistent with the concept of allocative efficiency which places emphasis on the choices made by decision-makers in response to the prices they confront.

In relation to ensuring security of supply, the Victorian market carriage arrangement operates under the following principles:

- (a) An obligation is imposed on VENCORP under the MSO Rules to operate the system in a manner designed to optimise the benefits across all users.

- (b) The rules applied are transparent and equitable, are common to all system users, and are based on the efficiencies derived from commercial competition drivers.
- (c) The gas transmission system is operated to so as to optimise the use of the system's capacity to transport gas at all times.

Where there is a threat to the security of the system, the MSO Rules set out VENCorp's obligation to optimise the use of system capacity to alleviate the threat. The MSO Rules provide VENCorp with a wide range of transparent and auditable intervention actions and discretion as to their use. This leads to better management of security risks and threats allowing for more efficient employment of available system capacity at all times, reduced potential for threats to the system and the resultant need to intervene, and improved reliability of customer supply.

The transparency of the market information systems provides real time knowledge of security issues to Participants. This facilitates and encourages market forces to contribute to the alleviation of those issues, by enabling Participants to make preparations in advance.

It is noteworthy that this transparency has also resulted in further improvement in VENCorp's operation leading to greater efficiency. A specific example is the improvement of the quality of VENCorp's demand forecasting which is critical to overall system security.

Under the MSO Rules for over 3 years the market has, reliably and on a daily basis, been able to adjust to changes in the supply and demand balance, resulting in very effective and efficient operation of the transmission network. Since market start, the market has managed threats to the security of the PTS without the need for intervention by VENCorp. One of these events involved a major interruption from Victoria's major supply source, Longford, for over 6 hours.

Accordingly, VENCorp submits that by establishing a uniform framework under which a competitive market can operate, the MSO Rules help promote reliability of supply while reducing the need for regulatory intervention. This in turn should facilitate further deregulation of the industry, such as the move to full retail competition.

#### **6.4 Protection Against Potential Market Abuse**

Public benefits are created where there are effective arrangements in place to enable monitoring of any potential market abuse. Effective processes to detect and address any market abuses provide increased confidence to actual and potential new market entrants, and reduce barriers to competitive entry.



The MSO Rules (clause 7.1) provide that VENCORP has a role to monitor the market and Participant compliance with the requirements of the MSO Rules, investigate any potential breaches of the MSO Rules, and to report on such to the Commission.<sup>56</sup>

## **6.5 Maintaining Consistency with Current Arrangements**

VENCORP submits that the following public benefits will arise by maintaining consistency and stability of the MSO Rules:

- (a) The market arrangements are consistent with requirements imposed by existing legislation and regulations. For example, the MSO Rules satisfy VENCORP's obligations as system operator and market administrator in respect of the gas transmission system under the GIA, and the Gas Pipelines Access (Victoria) Act 1998. Retailers using the gas transmission system are required by the GIA and licences administered by the ESC to comply with the MSO Rules. Also, each of VENCORP, GasNet, and the retailers and distributors who use the PTS, must comply with the MSO Rules as part of their approved safety cases under the Gas Safety Act (Vic) 1997 and associated regulations.
- (b) The arrangements are consistent with access arrangements submitted by other participants in the Victorian gas market. The MSO Rules align with VENCORP's and GasNet's revised access arrangements submitted to the Commission, and the three Victorian distributors' revised access arrangements submitted to the ESC (all of which were submitted in March 2002 to come into effect from 1 January 2003). All of these arrangements were submitted on the basis of market carriage and continued operation of the MSO Rules and the Retail Gas Market Rules.
- (c) An environment of stability and certainty assists commercial decision making by Market Participants. Substantial investment has been made by Participants in developing an understanding of the MSO Rules and putting in place commercial processes to undertake operations and planning consistent with the MSO Rules. In particular:
  - Participants such as new gas field developers, gas retailers and electricity generators, may have made decisions and entered into commitments based on an assumption of continuation of the MSO Rules; and
  - all Participants are dependent on the integrity of systems for metering and billing, and reliability of settlements and prudential requirements.

There is a significant public benefit in maintaining commercial stability in the market arrangements, such that Participants can focus resources on

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<sup>56</sup> VENCORP's monitoring role and the absence of any evidence of anti-competitive behaviour by Participants is further detailed in **section 7.3**.

managing other aspects of their businesses (rather than possible changes to the trading arrangements). More specifically, there are public benefits in Participants' continued participation in a market without concerns about the consequences of default by other parties, or the need to incur the consequential costs associated with managing such risks.

Similarly, it is widely acknowledged that regulatory uncertainty affects price and investment.

See for example, observations by the Australian Financial Markets Association ("AFMA") in the electricity market context that:

*"...regulatory uncertainty has contributed to the lack of risk capital entering the Australian electricity market. Every time a regulatory body or government announces a review of the NEM or suggests any sort of reform it has a deleterious effect on the efficient development of the NEM."<sup>57</sup>*

Similarly, AFMA's submission to the COAG Energy Market Review, April 2002, states at page 3:

*"Many participants are reluctant or unwilling to enter long-term price risk management contracts where there is a risk that regulatory intervention could impact the value of such a contract...."*

and at page 4, in relation to the interaction between wholesale and financial markets:

*"The connection between the operations of wholesale and financial markets is one of such great importance that it must be fully considered in moving forward. With a well-established financial market structure, there are great costs to participants (and thus end users) when wholesale market changes occur without due consideration of the negative impacts on financial markets. While any impact should not in itself prevent a Code change, the disruption it may cause to risk management contracts already in place should be considered when assessing the overall benefit of any change."*

- (d) Avoiding unnecessary disruption of a live market through any actions pursuing alleged or potential infringements of the TPA, thereby avoiding unnecessary costs for defending such actions and associated risks. In particular, authorisation would:

- avoid the need for wholesale revision of contracts; and

<sup>57</sup> Comments by AFMA on 24 May 2001, as reported in the Power Industry News 24 May 2001.

- avoid complexity and uncertainty in renegotiation of such contracts should arrangements be considered to be open to challenge under the TPA.

There is a live market in operation which has developed under the existing authorisation, and the risk of such disruption would have implications for the efficiency and competitiveness of the market's continued operation.

- (e) Continued use is made of existing investments in systems and processes. A substantial public and private investment has been made by VENCORP on behalf of the Victorian Government in the systems and processes that are required to operate the gas market in accordance with the MSO Rules. Again, while change should not be ruled out, it should be recognised that the systems and process are highly specific to VENCORP's requirements and would have little value in an alternative use.
- (f) The MSO Rules provide efficient and transparent dispute resolution processes.
- (g) Implementation of gas full retail competition. Following extensive industry and customer consultation over the past 2 years the Retail Gas Market Rules have been approved and authorised by the ESC under the GIA, and customer transfer systems, profiling systems etc have been built in readiness for full retail competition in October 2002, all on the basis of continuation of the MSO Rules and current wholesale market arrangements.

## **6.6 Facilitate Retail Competition**

The retail market encompasses gas retailers and gas consumers that do not participate directly in the wholesale market. "Retail competition" involves competition amongst retailers to earn a margin by supplying customers with gas and other services (such as electricity).

The principal function of the retailers is to aggregate and manage all the various services to enable delivery of gas to the customer.

In its 1998 Determination, the Commission expected that the MSO rules would facilitate retail competition, even though the MSO Rules do not directly incorporate the retail sectors.

Retail competition has been progressively introduced so that customers consuming in excess of 5TJ are now free to choose their gas retailer, and full retail competition is anticipated later this year.

VENCORP submits that:

- (a) consistent with expectations in 1998, the retail market has developed competitively as indicated by:

- the increase in the number of Market Participants operating in the Victorian markets;
  - churn rates among customers supplied gas from the PTS; and
  - customer transfers taking place without difficulties or major delays; and
- (b) market carriage has positive effects on retail competition as compared to contract carriage.

VENCorp considers that it has been clearly demonstrated that the MSO Rules facilitate retail competition. Further VENCORP submits that full retail competition for domestic customers will also be facilitated by the MSO Rules, and the Retail Gas Market Rules which were developed consistent with, and in reliance on, processes under the MSO Rules.

#### **6.6.1 Development of the Retail Market**

One of the expected benefits of the market arrangements was that each Participant, regardless of its size, would be able to access the same market clearing price to buy or sell spot gas. This was expected to remove the advantages that large players, who can more easily manage risk, would have under a "traditional" US model.

Government restructuring of the Victorian gas industry created three initial retail businesses. Since the adoption of a market carriage system operating under the MSO Rules, Victoria now has 13 registered Market Participants, of which 8 are licensed retailers. As well as retailers, the Market Participants include traders and a market customer purchasing directly through the wholesale market. This is in accordance with prior expectations.

While high churn rates are not in themselves necessarily an indication of an efficient competitive market, where high churn rates exist, they indicate a lack of impediments to customer switching.

Churn rates for currently contestable customers on the PTS have been in excess of 20%.<sup>58</sup> Based on anecdotal evidence VENCORP submits that these rates compare favourably with other markets. A key factor in the introduction of this competition is the flexibility created by the MSO Rules which allows large retail customers to switch between retailers.

On the Victorian pipeline systems which have operated outside the MSO Rules (such as the Western Transmission System), VENCORP submits there have been three key impediments to customer churn. These are:

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<sup>58</sup> While there has been a to date low churn rate in the 5-10TJ customer group, due to a lack of cost effective metering, the average overall is high, as churn rates for customers with consumption greater than 10TJ exceed 25%.

- (a) the lack of rules such as those in the MSO Rules to facilitate and compel transfers;
- (b) the lack of allocation agents and systems to effect transfers; and
- (c) capacity contracts between pipeline owners and incumbent retailers, which commit all existing pipeline capacity.

#### **6.6.2 Effect of Contract Carriage Model on Retail Competition**

Experience in Victorian pipeline systems outside the MSO rules also indicates that where a proposed transfer is of an existing customer with an unchanged load (such that there will be no net increase in gas throughput), that transfers are impeded because:

- (a) a new retailer cannot compel an incumbent retailer to relinquish its capacity rights<sup>59</sup>;
- (b) in the absence of expensive pipeline augmentation, the pipeline owner will offer only interruptible supply to a new retailer; and
- (c) if the customer accepts interruptible supply, the former incumbent retailer may sell the firm capacity rights to another customer.<sup>60</sup>

This contrasts with the market carriage model applied by the MSO Rules to the PTS, where there is no requirement to contract for pipeline capacity and no ability for "incumbent" retailers to fully contract capacity and prevent access to new entrants. Under the MSO Rules, a new retailer can secure an existing customer (together with the customer's AMDQ which has been allocated by VENCORP in respect of that customer's site) without the need to negotiate with the incumbent retailer for release of the incumbent's capacity rights. Thus, if a customer has been allocated AMDQ by VENCORP, that customer retains its AMDQ rights even if it changes retailer, or if the customer becomes a direct registered wholesale market customer.

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<sup>59</sup> The preferred solution is for the incumbent retailer to sell capacity rights to the new retailer. However, one key characteristic of the access regime embodied in the Code is preservation of existing contractual rights. Even if transfer systems were in place, no one can compel an incumbent retailer to relinquish or sell existing contractual rights to pipeline capacity.

<sup>60</sup> The Code provides mechanisms for prospective or existing users to seek system enhancements to achieve additional capacity. It also requires queuing policies, public registers of spare capacity, and (retailer) disclosure of unutilised contracted capacity. However, a transfer to a new retailer of an existing customer with a constant load which would not alter the net gas flows through the system, ought to be able to occur without system enhancements. For example, VENCORP was approached in 2001 by a large customer in the Western System, who was concerned that their proposed transfer would not result in any variation to the gas quantity flowed through the pipeline system. Therefore, the customer considered system augmentation to be an unnecessary costly impractical solution.

This view has been publicly supported by new entrants. For example, Ergon Energy noted:

*"Ergon Energy supports the objectives of the market carriage model and the flexibility that it can provide to smaller gas retailers. In theory, this model creates an environment where small retailers do not necessarily have to enter into long-term take or pay contracts in order to gain access to pipeline systems. However, the risks associated with sourcing gas from the wholesale market have prevented new retailers from competing.*

*The contract carriage model is likely to be heavily favoured by the transmission and distribution service providers, due to the greater revenue certainty that long term, fixed-volume contracts provide. However, this model can result in a pipeline system whose capacity is fully contracted, yet under utilised, making the system inefficient. Access to pipeline systems (i.e. capacity) under these circumstances can often only be gained by new entrants after an extended waiting period and under onerous terms. The trade of capacity under this model allows some flexibility, however trades rarely occur.*

*The market carriage model encourages pipeline owners to utilise the pipeline capacity at its most efficient level by providing access to all interested parties, instead of the "lock-out" which can occur in the contract carriage systems."<sup>61</sup>*

## 6.7 Harmonisation of Energy Markets

International experience suggests that the key features required for a competitive and efficient national energy market are as follows:

- (a) Structural disaggregation such that a competitive environment exists for market participants without significant attribution of market power to any sector(s) to the disadvantage of others.
- (b) Market arrangements that internalise all effects, especially network interactions.
- (c) Well-defined and enforceable property rights.
- (d) Practical ways to trade rights and/or price interactions.
- (e) A supportive political, legal and social framework.
- (f) An infrastructure of monopoly or non-market facilities (such as physical, legal and social infrastructure) that could not be produced by themselves.

<sup>61</sup> Ergon Energy – Public Submission, dated September 2000, to VENCorp Issue Paper on Review of the Gas Market Arrangements.

VENCorp submits that the Victorian gas market arrangements and the MSO Rules are consistent with these features, particularly insofar as the MSO Rules promote transparency and efficiency and create a level playing field for all Participants.

The market carriage arrangements made under the MSO Rules have been developed with the distinguishing characteristics of the Victorian industry and the PTS in mind. However, the MSO Rules may also promote harmonisation of energy markets through:

- (a) their ability to interface effectively with other pipeline systems. This is consistent with the experience in the United States, where different trading arrangements are in place on interconnecting pipelines. These differences are not found in practice to create substantive barriers to trade between the systems;
- (b) a positive impact on interstate trading between Victoria and NSW (refer to **section 6.1.4** above); and
- (c) allocative efficiency through promotion of price discovery.

VENCorp submits that public benefits are likely to arise from the MSO Rules in time, to enhance price discovery in the South East Australian gas market, and improve price discovery and efficiency in the National Electricity Market.

The combined effect of increased access to new markets (as a result of the development of pipelines to Tasmania and South Australia, the existing Eastern Gas Pipeline to NSW, and the interconnect to NSW) and potential new sources of gas supply, give rise to the prospect of a Longford, or Victorian "hub", linking the Victorian, NSW, South Australian and Tasmanian markets.

VENCorp expects that the spot prices published for daily trades in the Victorian PTS are expected to be closely related to spot and forward gas prices for gas that might be traded at such a Victorian hub.

The AGA <sup>62</sup>recently stated:

*"Given the relative immaturity of the Australian gas market major wholesale developments such as 'gas hubs' in the US have yet to develop. The benefits of these gas hubs can include a more transparent and flexible market in a range of value added services such as swaps and physical backhaul".*

*Wholesale market arrangements are limited in Australia by the absence of vigorous upstream competition.*

<sup>62</sup> AGA submission to the COAG Energy Market Review April 2002.

Further, TXU Australia<sup>63</sup> noted recently:

*"The Victorian Market will provide transparency to other Australian markets where interconnecting pipeline capacity is available. This is already happening in NSW, and will happen in South Australia should pipeline capacity to Adelaide become available. The market is coming!"*

Public benefits are created by facilitating appropriate levels of security of supply at minimum economic cost in related markets for essential services.

In the Victorian and South Australian electricity markets, this is highly dependent on the reliable operation of gas-fired peaking and reserve generators. As the growth in peak demand continues in coming years, the importance of the role of gas-fired generation is expected to increase.

In other markets internationally, the growing importance of managing rapidly varying demands on transmission pipeline systems created from gas-fired power generators is increasingly being recognised as a problem. (For example, Ofgem is considering proposals to move to a within day (6 hour) balancing period in the UK gas market.<sup>64</sup>)

VENCorp submits that:

- (d) through the creation of the efficiencies as described above and the promotion of a competitive market for gas, the relative price and appeal of gas compared to other forms of electricity generation, has and will continue to be, improved; and
- (e) through the provision of reliable transportation, balancing and system security services to the Victorian gas market, the reliable operation of gas fired generators will be facilitated.

The development of reliable and cost efficient gas-fired electricity generation in turn will assist in ensuring the security of Victoria's electricity supply during periods of peak electricity demand.

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<sup>63</sup> Speech by Manager Gas Trading of TXU Trading, Mr Andrew Brown, to the VicGas conference in October 2001.

<sup>64</sup> "The New Gas Trading Arrangements", OFGEM, February 2002.



## **7 POTENTIAL PUBLIC DETRIMENT**

These applications are made because the MSO Rules or conduct contemplated by the MSO Rules may contravene the TPA. The issue for the Commission is whether such conduct could result in public detriment, how material and likely is this, and whether the public benefits arising from the conduct outweigh any potential detriment.

The Commission examined these aspects in detail in reaching its 1998 Determination. As will be demonstrated in the following sections, any potential public detriment identified by the Commission in 1998 has not eventuated, or has been immaterial.

Additionally, since inception there has been both widespread public support for the MSO Rules, but also continued public comment from some sectors in regard to perceived or potential detriments of the MSO Rules. Whilst not accepting that this comment indicates any form of detriment either exists or could potentially be caused by the MSO Rules, for the purpose of assisting the Commission, these areas are incorporated in the following discussion. As will be clearly demonstrated, these concerns have not been substantiated, and operational experience has demonstrated otherwise in all cases.

### **7.1 Potential for Market Distortions**

The 1998 Determination identified:

- (a) single zone daily pricing;
- (b) market intervention and force majeure provisions;
- (c) VoLL<sup>65</sup>; and
- (d) competitive advantages to foundation participants,

as aspects of the MSO Rules that may have the potential to create market distortions leading to a lessening of competition, or act as barriers to entry. As detailed in the following, VENCorp submits this has not been the case.

#### **7.1.1 Single Zone Daily Pricing**

The MSO Rules implement pricing arrangements whereby the price for gas is established by the outcomes of the competitive market. The current methodology implements a simplified pricing arrangement, whereby the market is cleared at a common price which is established ex post and is applied uniformly across all locations for every hour of the gas day. This simplification was adopted prior to market start to assist Participants during the period that saw the introduction of extensive structural change and competitive reform.

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<sup>65</sup> A price cap on the market price, VoLL, which implies Value of Lost Load.

However, the value of gas changes during the day and between locations, and this method of pricing does not capture all of the externalities caused by network constraint effects. The gas transmission network cannot in fact be treated as a simple daily, non-physical model for scheduling. Managing the network requires that scheduling incorporate all the network effects. As a consequence of the simplified approach to pricing, additional compensatory payments are required to ensure that parties at least remain whole to bid when complying with the instructions of the system operator. These payments are funded by uplift payments from Participants.

The Commission noted that:

*"this 'simplified' design has the potential to create a number of distortions including increasingly uncertain uplift payments, in terms of size and timing, as demand grows. In addition, a single daily price will not value gas over different times of the day and different locations, hence weakening locational signals for investment purposes."<sup>66</sup>*

The Commission required as a condition of the Current Authorisation that VENCorp undertake a review of the introduction of locational hourly pricing within two years of market commencement. VENCorp undertook this review through a thorough public consultation process led by the GMCC. The strong recommendation of the GMCC was that there was presently no justification for locational and hourly pricing. However, the VENCorp Board adopted GMCC's recommendation that a broader review of the market arrangements be undertaken throughout 2000 to update the position on locational and hourly pricing and identify any other areas of the market arrangements where substantive change may be pursued to improve the market's overall efficiency or effectiveness.

This review of the market arrangements was completed in early 2001 with the conclusion that there was presently insufficient justification to move to locational and hourly pricing<sup>67</sup>, and that as a consequence further work should proceed to examine areas such as:

- (e) AMDQ trading;
- (f) the uplift allocation methodology; and
- (g) linepack management.

Each of these were identified as areas with the potential to provide for cost effective modifications to the current arrangements to improve market efficiency and effectiveness in the management and allocation of costs of within day effects or pipeline congestion.

<sup>66</sup> 1998 Determination at page 26.

<sup>67</sup> The lack of clear justification for locational and/or hourly pricing has been based on market experience to date and projections of future outcomes in terms of uplift payments and uplift risk management. Refer to the report "Review of the Victorian Gas Market Arrangements", VENCorp 15 March 2001.

Subsequently, changes to the MSO Rules have been made and authorised by the Commission to introduce AMDQ trading (June 2001), and VENCORP is currently undertaking a consultative process to review the uplift allocation methodology, and a review of the linepack arrangements has been scheduled to commence following completion of the uplift review.

In addition, VENCORP has commissioned 5 independent major reviews of the extent of the externalities and the risks which arise from uplift payments. Each of these reviews showed that the risks are immaterial as impediments to competition or a barrier to entry.

Operating experience in the market to date has justified this pragmatic approach to the development of more sophisticated pricing arrangements.

In the three and a half years of market operation the total uplift charges levied is only approximately \$1.1M, which represents on average only a fraction of a cent per GJ. The worst accumulated net uplift position of any Market Participant since market start is less than \$75,000, which equates to a small fraction of a cent per GJ. This net position consists of net monthly receipts and payments, so it is also worth noting that the worst net position of any retailer in any one settlement month over the entire period since the market opened, has been less than \$65,000, which represented approximately 0.9c/GJ loading on their monthly throughput in the month in question<sup>68</sup>. In practice, the net exposure is typically much less, equating to a small fraction of a cent per GJ.

While it is acknowledged that the single zone and daily pricing model can give rise to a "smearing" of the costs of managing within day events rather than allocating costs to the cause, the consequences of this have been immaterial to date. Nevertheless, a consultative framework exists to enable the matter to be reviewed should circumstances change (for example, if significant additional gas-fired generation were commissioned)<sup>69</sup>, and VENCORP is currently undertaking a review of the uplift allocation methodology to seek improvements in this area. This work is proceeding via the GMCC.

### **7.1.2 Market Intervention and Force Majeure Provisions**

#### **(a) Market Intervention Provisions**

In its 1998 Determination, the Commission considered whether:

*"the arrangements under the MSOR by which VENCORP is required to issue directions in an emergency may be anti-competitive because VENCORP's intervention could substantially lessen competition in the Victorian gas industry."*<sup>70</sup>

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<sup>68</sup> Being June 2000.

<sup>69</sup> VENCORP also notes the recent shift in the United Kingdom to 6 hour balancing.

<sup>70</sup> 1998 Determination at page 138.

Since market commencement in 1999, VENCORP has not had to intervene in the market and issue directions to resolve any emergencies or events that could result in an emergency. The system has been stressed on numerous occasions, both from the point of view of AMDQ transport capability and localised issues. There have been several incidents and one instance of a formal threat to system security<sup>71</sup>. A market solution was found in every case.

The MSO Rules have proven flexible enough to respond to the following events, all without any market intervention by VENCORP<sup>72</sup>:

- Significant transportation constraints caused by spike loads:
  - an electricity market supply emergency with gas generation directed by NEMMCO at short notice (2 November 2000); and
  - several instances of significant and unexpected changes in demand by spike loads.
- Supply interruptions:
  - gas supply failure at Longford (19 July 2000); and
- System stresses due to combined demand and transportation requirements:
  - twelve days where the daily throughput has exceeded 990TJ (the nominal capacity of the PTS); and
  - two days of extreme high demand (above 1100TJ).

In each case, the MSO Rules allowed the market to develop a competitive response for managing system operation and delivering market-based outcomes.

VENCORP does not consider that any other set of arrangements would have provided such an outcome. Further, VENCORP considers that arrangements based on contract carriage, if such could be developed to work on the Victorian system, would have resulted in frequent intervention by the system operator through the issue of operational flow orders. This would almost certainly have been the case in each of the instances noted above. The MSO Rules therefore provide a real and substantial reduction in the need for system operator intervention in the market and the commercial arrangements of businesses and customers, which would not otherwise be the case.

Should VENCORP eventually be required to intervene at some stage in the future, the MSO Rules prescribe as much transparency and rigour around such actions as is

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<sup>71</sup> Arising from a supply issue when all supply from Longford was lost for a brief period on 19 July 2000.

<sup>72</sup> Reports on these matters are available on VENCORP's website.

possible. The System Security Guidelines developed by VENCORP prescribe thresholds to be breached before any intervention is undertaken, and provide every means for a market-based solution to be developed by the Participants before intervention becomes essential.

VENCORP notes that Chapter 6 of the MSO Rules provides for a review within five years of market commencement, implying that these provisions must be reviewed over 2003 to meet the required condition.

**(b) Force Majeure Provisions**

In its 1998 Determination, the Commission considered whether:

*"the arrangements in clause 6.7 may be regarded as price fixing, as they entail the imposition of an administered price cap", and whether "the public benefit of protecting the Victorian gas industry from price shocks due to specific events, such as industrial disputes, ...[outweighed] their possible anti-competitive detriments"*

The Commission was of the view that protection of spot sales from force majeure events has the potential to decrease efficiency, but nevertheless, concluded that protection of the Victorian gas industry from spot price outcomes resulting from events outside the boundaries of design expectations was warranted.

The force majeure provisions in the MSO Rules are designed to replicate a reasonable commercially negotiated position so that Participants can be assured that they will be protected.

A significant amount of work was completed in this area. In September 1998 VENCORP engaged Trowbridge Consulting on behalf of the GMCC to investigate and make recommendations on three key interrelated market issues:

- provisions for, and definitions of, force majeure;
- triggering and level of administered price cap; and
- guidelines for the determination of compensation payments.

Trowbridge consulted with industry and worked closely with the GMCC in developing its recommendations, and concluded<sup>73</sup> that the definition of force majeure should be broadened to include a greater range of events than supported by the Commission in the 1998 Determination. It also established a value for the administered price cap based on consideration of the marginal cost of the then available gas resources and alternative fuels.

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<sup>73</sup> Trowbridge Consulting Report "Review of the Force Majeure (FM) and Administered Price Cap (APC) Provisions for the Victorian Gas Market", November 1998.

### **7.1.3 Ceiling Price Cap (VoLL)**

The value of lost load (VoLL) is a cap on the spot price for gas when supply fails to meet demand. The issue before the Commission in its 1998 Determination was whether such a mechanism constituted a form of price fixing under s. 45 of the TPA. The Commission compared the potential anti-competitive detriment arising from the imposition of a price cap with the benefits of avoiding price spikes which might occur before both customers and gas suppliers have had the chance to fully establish response mechanisms.

The Commission noted that:

*"The primary rationale for the price cap is to ensure that the Victorian gas industry is not subject to large price shocks. Without a price cap retailers in particular could be exposed to financial detriment and potentially, bankruptcy. Thus VoLL may have an important role to play in the initial stages of the market. However, exposure to VoLL will be reduced to the extent that customers are able to use financial instruments to hedge against such price risk."*<sup>74</sup>

The Commission decided in its 1998 Determination that, on balance, there was a public benefit in having VoLL, and VENCorp submits that the Commission's reasoning and conclusion remains applicable.

In 1998, concerns were raised that in the longer term, VoLL would lead to supply shortage and intervention by VENCorp. As the Commission recognised, "Establishing the appropriate level of VoLL is important. VoLL, or the price cap, will be a fundamental market signal for long term investment."<sup>75</sup>

In practice, VoLL assists with reliability of supply, by providing a price signal that feeds into risk management and investment decision-making, and that reflects costs to community of loss of supply which cannot be dealt with by other market-set prices. It also gives certainty in the transition from historical centralised-planning monopoly to a dynamic market.

VENCorp conducted a review of VoLL during 2001 through a transparent, consultative process. The review concluded that there was insufficient concern raised to warrant any change or further work, with no Participant indicating that the level of \$800/GJ posed significant risk to management costs.

VoLL has not distorted market outcomes, with the highest price to date being \$5.45/GJ.

### **7.1.4 Competitive Advantages**

In the 1998 Determination, the Commission identified:

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<sup>74</sup> 1998 Determination at page 96.

<sup>75</sup> Discussed in section 8.6 of the Commission's 1998 Final Determination.

- (a) allocation of LNG;
- (b) allocation of AMDQ; and
- (c) End of Day Linepack (EoD Linepack) capacity rights,

as features of the MSO Rules that may provide foundation participants with a competitive advantage over those who subsequently enter the industry<sup>76</sup>. There was concern from the Commission that this possible competitive advantage might create a barrier to entry for new Participants.

In practice, this has not been the case. The MSO Rules have not given rise to barriers to entry from scope or size considerations of the foundation Participants. There is no evidence of the MSO Rules providing the means for strategic entry deterrence by the incumbents.

In support of this assessment, VENCORP submits these matters have not been raised by new or potential new entrants as substantial barriers. In fact, parties wanting to enter into gas retailing have clearly stated<sup>77</sup> that the most significant issue to them for entry to the wholesale market for the purpose of retailing is the lack of upstream competition and ability to get access to competitively priced, firm supplies of gas from producers.

The MSO Rules put in place arrangements to foster competition and reduce barriers to entry to, and exit from, the wholesale market. While this can, in turn, facilitate upstream development, the underlying issue is not one that is caused by or capable of being resolved by the MSO Rules.

More particularly, in the context of the Commission's previous concerns, VENCORP notes the following:

- (a) EoD Linepack capacity rights related to a financial model that was not implemented in practice. Those rules that related to EoD Linepack were removed in amendments which were authorised by the Commission in December 2001. The industry has committed to examine the development of a form of physical linepack rights model following completion of the current review of the uplift allocation methodology<sup>78</sup>.
- (b) AMDQ is now fully transferable. These arrangements are flexible and further facilitate bilateral contracting outside of the spot market.

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<sup>76</sup> 1998 Determination at page 27.

<sup>77</sup> For example, Energex and Ergon Energy in response to the public consultation by VENCORP on review of the Victorian gas market arrangements – refer page i of the foreword to the report "Review of the Victorian Gas Market Arrangements", VENCORP 15 March 2001.

<sup>78</sup> This was identified as a priority in the outcomes of the review of the market arrangements undertaken under the auspices of the GMCC in 2001. However, initial investigations undertaken during the market review have shown that this is only limited scope for such due to limitations caused by the physical characteristics of the Victorian transmission network.

Prospective shippers are not normally constrained to shipping quantities of gas commensurate with their AMDQ rights to book capacity. The market carriage arrangements expressly facilitate entry by allowing new entrants to use the system without the need to book capacity, as it allocates system capacity on the basis of efficient usage, optimising its operation to give effect to this, and then pricing based on that usage.

- (c) In relation to the allocation of LNG, the initial contracts between GasNet (as owner of the LNG facility) and the three incumbent retailers all expire on 11 December 2002. Prospective users of this service are currently negotiating commercial terms with GasNet for acquiring allocations of the LNG storage capacity. New entrants and prospective entrants are able to negotiate on commercial grounds with GasNet for LNG storage capacity. Retailers may also approach the Western Underground Gas Storage facility as an alternative source of storage, or may pursue other prospective sources of new supplies.

## **7.2 Potential for Barrier to Entry – Accountability and Liability**

In its 1998 Determination the Commission identified that:

- (a) VENCORP's consultation procedures;
- (b) disclosure of VENCORP expenditures;
- (c) VENCORP's limited liability; and
- (d) reporting of VENCORP interventions,

could all be areas of possible concern.<sup>79</sup>

With the exception of VENCORP's liability, all of these matters were addressed through rule changes imposed as conditions of the Current Authorisation.

In considering the provisions in the MSO Rules which related to VENCORP's liability, a specific issue was whether the establishment of the Participant Compensation Fund ("PCF")<sup>80</sup> could constitute a barrier to entry or cause a "moral hazard"<sup>81</sup>. Regarding VENCORP's limited liability, the Commission noted:

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<sup>79</sup> 1998 Determination at page 27.

<sup>80</sup> At the time of its 1998 Determination, the arrangements surrounding the PCF were inadequately defined and the Commission was concerned that charges for funding contributions to the PCF and the fact that compensation from the fund was limited could mean that the provisions might have the potential to act as a barrier to entry.

<sup>81</sup> "Moral hazard" refers to circumstances in which a person fails to exercise an appropriate standard of care because it has no incentive to do so given limitation on liability.



*"VENCorp and its related bodies are funded by market participants and are operated on a cost recovery non-profit basis. Thus, it is arguable that any payments for claims made against these bodies or any costs incurred in having to insure against such claims will be reflected in higher participant fees to cover this risk, which may deter entry of smaller participants. This cost may ultimately be passed through as higher end-user charges.*

*Conversely, limiting liability for errors shifts the balance of risk to each participant which will impose a cost in the form of their having to cover any loss if errors occur, or pay for private insurance to cover potential loss. This cost may again deter entry, particularly for smaller participants, and the cost may be passed on to end-users....*

*On balance, the Commission considers that limiting the liability of VENCorp for losses due to errors may be more appropriate at this time. However, the Commission is also mindful that the VENCorp Board is made up of interested parties. If there are enough interested parties who require VENCorp to insure itself, the onus is on those parties to seek a change in the liability provisions."<sup>82</sup>*

The Commission ultimately decided that VENCorp's level of liability should be determined by Participants who will have to bear any costs through either higher insurance premiums or increased market fees, and VENCorp carried out the Commission's requirement for it to undertake a consultation process prior to market commencement.

It is notable that this review, and a subsequent attempt by VENCorp to review the relevant provisions, met with the unanimous view from Market Participants (including those who were vocal on this issue during the 1998 Determination process) that such a review was unwarranted with potential costs exceeding benefits. The results of the consultation<sup>83</sup> were conveyed to, and accepted by, the Commission.

In respect of the PCF, the fund's arrangements were finalised with industry and accepted by the Commission prior to market commencement, and the resultant charge to Participants was less than 0.03 cents per GJ.

There have been no claims against the PCF since market commencement, and no market interventions.

The balance of the PCF is currently approximately \$1.5 million (and accruing interest of approximately \$5,000 per month). Participants reviewed the level of the PCF in 2001 and agreed to halt further contributions (it was agreed to review this position if and when a claim reduced the balance below \$1m). Therefore, at this point in time, no further costs are being incurred by Participants in this regard.

<sup>82</sup> 1998 Determination at page 55.

<sup>83</sup> Review by Ernst & Young 99/01.

VENCorp submits, therefore, that actual events over the past three years have shown that the limitation of VENCORP's liability and establishment of the PCF has not constituted a barrier to entry.

VENCorp also submits that in the past three years it has not exhibited any lack of care, or a "culture of immunity".

VENCorp is fully accountable under the GIA and MSO Rules for system operations and security, with associated costs and processes being transparent and certain. Further, as detailed earlier, VENCORP's Board includes independent and industry representative directors who ensure that VENCORP and its officers are appropriately controlled. VENCORP has a formal risk management policy and formal change management processes are implemented throughout the organisation.

No one has suggested or identified any area where VENCORP or its officers have not acted with appropriate care. Further, there is no evidence based on operational experience that any other party, financially liable or otherwise, would have operated the system more effectively than VENCORP has to date.

VENCorp also notes to the Commission that:

- (a) VENCORP actions in regard to market operation are audited by independent market auditors, VENCORP's corporate behaviour and financial statements are audited by the Auditor-General's office, and VENCORP's corporate plan is subject to approval by State Government Treasury and its annual budget by the Commission itself;
- (b) market audit reports generally indicate a high degree of compliance, but nevertheless, VENCORP's Board of Directors requires that any action items arising from the audit be attended to as a matter of priority;
- (c) scheduling and pricing are determined by independently certified market clearing software, making the processes robust and transparent;
- (d) VENCORP is introducing competency based assessment for operating staff;
- (e) VENCORP's obligations are reinforced through its approved safety case, which is audited by the Office of Gas Safety; and
- (f) unsolicited letters from Market Participants have complimented VENCORP on its operations during critical periods.

VENCorp submits that no public detriment has arisen in this area, nor should any be anticipated.

### **7.3 Potential for Tacit Collusion or Price Manipulation**

Each day, VENCORP publishes a wide range of information on the market and system operation, including schedules and forecasts of price. Following the gas day, VENCORP publishes further information relating to the gas day, including actual market outcomes, details of its system operation, and, Participant bids. This

information is made available to all Participants via an information bulletin board, and most of it (excepting private Participant-specific information relating to commercial outcomes) is provided to the wider public via VENCorp's website.

In its 1998 Determination, the Commission noted its concern that:

*"the market information collected and published by VENCorp could potentially be used by market participants to engage in anti-competitive conduct ...in contravention of s. 45 of the Trade Practices Act.*

*Further, the market information could be used to manipulate spot prices for commercial advantage by some market participants. While such behaviour does not contravene the Trade Practices Act, it could nevertheless significantly detract from the potential public benefits of the market arrangements."<sup>84</sup>*

The Commission also noted that it was:

*"important that participant behaviour be subject to an active monitoring process. Such monitoring should provide important information regarding compliance with the MSOR and the adequacy of the MSOR.....Broadly, this role should involve determining whether market participant behaviour highlights areas in which the existing rules need to be changed. Monitoring should also involve an assessment of behaviour, and the Commission strongly urges all participants to take an active role in monitoring market behaviour. ....the Commission agrees that VENCorp's role should be limited to the reporting of facts concerning the operation and status of the system. Any concerns arising out of such information may be considered by the Commission, which may take action under the Trade Practices Act if the conduct involves possible contraventions."<sup>85</sup>*

Such a role was developed and subsequently approved by the Commission, and has operated since market commencement, with VENCorp actively monitoring and reporting at regular intervals on market outcomes and Participant compliance with the MSO Rules.

VENCorp and the Commission entered into a memorandum of understanding in this regard, and further implemented operational protocols which define the Commission's expectations for VENCorp's monitoring of market behaviour. As the Commission would be aware, VENCorp is required under clauses 1.2.1 and 7.1.5 of the MSO Rules to report on such matters to the Commission. This process has been in operation since market commencement and VENCorp has not found any evidence to give rise to concerns of anti-competitive behaviour.

Further, VENCorp submits that one of the essential elements for a competitive market is that sufficient information is provided, on an equitable and efficient basis, to both

<sup>84</sup> 1998 Determination at page 127.

<sup>85</sup> 1998 Determination at page 131.

incumbents and prospective entrants. This enables all parties to make informed decisions about their businesses and the risks involved. Inability to obtain relevant market information can be a key barrier to entry and may lead to a general lessening of competition amongst incumbents. As detailed in **section 6.1.6**, the information provided under the MSO Rules also satisfies an important pre-requisite for investment decisions which leads to consequential economic development.

In 1998, the Commission decided that, the benefits from disclosure clearly outweighed any concerns it held over potential for gaming or tacit collusion, and authorised the provisions of the MSO Rules relating to information provision. VENCorp submits that actual experience over the past three years confirms the Commission's original position. The information disclosed in accordance with the MSO Rules has promoted competition while there is no evidence of such disclosure resulting in any anti-competitive behaviour.

#### **7.4 Restrictions on Conduct**

The MSO Rules govern conduct relating to:

- (a) entry to the wholesale gas market(s);
- (b) participation in the wholesale gas market; and
- (c) operation of the wholesale gas market and the Victorian gas network,

by imposing obligations on parties and providing a legal framework to provide for the rights of parties.

As such, certain aspects may be seen to potentially contravene certain provisions of the TPA.

However, these conduct restrictions do not lead to a lessening of competition or to public detriment. Rather, they:

- (a) simply ensure that the requirements for managing a gas transmission network are satisfied appropriately;
- (b) restrict actions that could otherwise lead to anti-competitive outcomes, lessening of competition and/or public detriment; and
- (c) enforce actions and requirements that support and enhance competition.

The MSO Rules provide a transparent and fair process that governs:

- (a) access to the transmission network and the services provided on that network;
- (b) operation of the system; and
- (c) the wholesale market for gas.

Further, the MSO Rules are necessary as a result of:

- (a) the removal of government ownership, as a consequence of the reforms in Victoria; and
- (b) the introduction of full competition in the gas transportation, distribution and retailing sectors.

In fact, most of the provisions relate to functions that are required to be undertaken on any gas transmission network (for example operational balancing, metering, billing, connection requirements, safety, gas quality, etc).

More specifically, the MSO Rules implement State legislation which vests operation of the transmission network with VENCORP, separate from the asset owner GasNet, and provides for VENCORP to administer and facilitate a wholesale market in gas. The MSO Rules therefore implement the obligations imposed on and the powers vested in VENCORP by the GIA as operator of the system.

Further, the MSO Rules provide a transparent, fair and public process for changing the Rules, one which takes into account the interests of all Participants. As the Commission noted in its 1998 Determination, "an effective consultation process would increase the public benefit of the proposed arrangements by ensuring that all participants' interests would be represented."<sup>86</sup>

## **7.5 VENCORP's Costs**

At the time of the 1998 Determination several interested parties questioned the need for a spot market and whether the potential costs involved were justified based on the possibly small volumes of gas being traded through such a market.

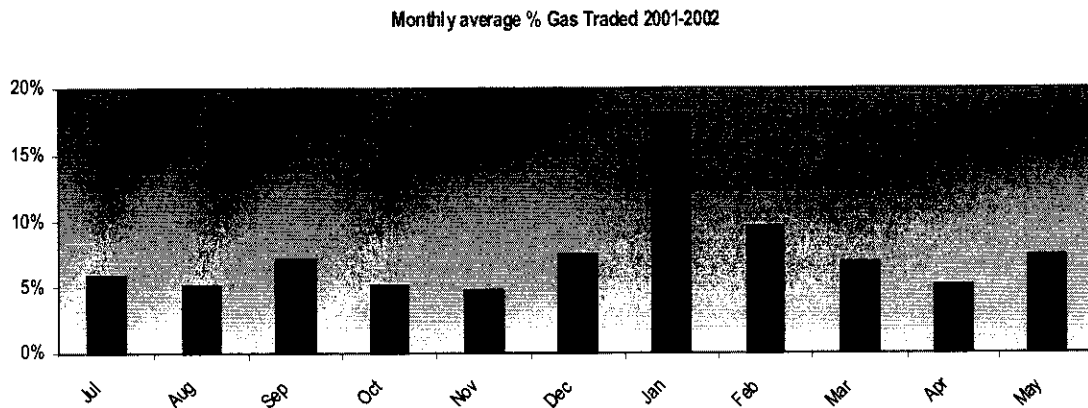
VENCORP's charges to Participants equate to only approximately 3-5 cents per GJ for retailers and large customers. These charges equate on average to about 1-2% of the delivered price of gas for most users and customers. The charges provide both an efficient spot market and managing capacity, and operation (of the system) which is fully integrated with the market. VENCORP's costs are about 15% of the total transportation tariff for shipping gas on the PTS. Further details are provided in VENCORP's and GasNet's proposed revised access arrangements for the period 2003-2007, currently being considered by the Commission.

**Figure 7.1** shows the monthly average trades over the last financial year. To date, daily volumes of gas traded on the Victorian spot market have averaged between 5-10% of total gas throughput, and are frequently in the 10%-20% range and on occasions have exceeded 40%. Accordingly, the level of gas traded via the spot market (and the economic benefits this has achieved) is reasonable given the constraints created by the Gas Sales Agreement.

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<sup>86</sup> 1998 Determination at page 159.

**Figure 7.1 – Monthly average gas traded as a percentage of throughput.**



Nevertheless, it should not be misconstrued that the benefits of the spot market and MSO Rules can be measured solely by the volume of spot market trades.

As Dr L.E. Ruff noted:

*"...any criticism which implies that the market carriage system does nothing except manage a little spot trading on the margin, fundamentally misrepresents the reality and value of the market carriage system.*

*"In fact, the VENCORP-operated market system performs many essential functions, including:*

- (a) gathering all the information needed for efficient and reliable pipeline operations;*
- (b) determining how the system operates;*
- (c) issuing and enforcing scheduling and dispatch instructions;*
- (d) managing metering information, settlements and prudential risk;*
- (e) providing an automatic, low-cost, market-based balancing service; and*
- (f) producing the reference prices used for essentially all retail contracting.*

*"These functions must be performed and paid for by somebody, and they benefit all users of the pipeline, including the vast majority who do most of their business under contracts. If these functions were not performed by VENCORP in a logical, integrated fashion, they would have to be provided in some non-integrated, ad hoc manner by others, probably at much higher cost and much less effectively. For example, the pipeline owner would have to establish and enforce some sort of contract carriage regime and would have to find some way to induce system users to provide the services needed to keep the pipeline operating reliably. Somebody would have to establish spot trading and settlement arrangements for dealing with imbalances. Somebody would have to gather and publish price data to facilitate trading and contracting.*

*"The implication of your criticism is that that all of this could be done for less than one percent of delivered gas costs – which is what VENCORP's total costs of 3-5 cents/GJ amount to. I have seen no evidence to support such a proposition and find it highly implausible on its face."<sup>87</sup>*

VENCORP concurs with Dr Ruff's comments and submits the level of costs for operating the PTS under the MSO Rules are prudent, reasonable and efficient and justifiable compared to the services provided and the economic benefits achieved through operating under the MSO Rules and market carriage system.

## **7.6 Complexity of the MSO Rules**

In its 1998 Determination, the Commission considered whether the perceived complexity of the MSO Rules could discourage new entrants, and if so, whether this was outweighed by the public benefit of having a comprehensive and accurate set of market rules.

Some parties submitted to the Commission that the perceived complexity, uncertainty and risks associated with the MSO Rules would act to render it infeasible for small entities to directly trade on the spot market and therefore, serve to discourage or prevent retailer bypass. In addition, the Commission considered whether the MSO Rules involved a degree of prescription that might retard innovation and the competitive benefits that result from innovation.

In light of practical experience in the operating market, VENCORP submits that these concerns have not eventuated. The matter of complexity is analysed more specifically in the following sections.

### **7.6.1 Complexity as a Consequence of Structural Reform**

The MSO Rules are more complex than the processes required before the disaggregation of the industry, but it cannot be said that the MSO Rules are more complex than any other system that provides the minimum set of functions required in a competitive and open access gas market.

To the extent that the MSO Rules are considered complex, this is a function of the interaction of the following features:

- (a) The disaggregation and unbundling of activities and services (retailing, transportation and storage).
- (b) The inherent complexity of providing open access consistent with ensuring system security and reliability.
- (c) Maximising the degree of freedom for Participants and minimising the need for intervention by the system operator.

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<sup>87</sup> Memorandum by Dr L.E. Ruff, 12 February 2001, in response to enquiries by Mr P Dobney on behalf of the Energy Users Association of Australia ("EUA").

The MSO Rules facilitate entry by a wide range of participants whose ability to participate would otherwise be circumscribed by the absence of appropriate structures and mechanisms.

#### **7.6.2 Complexity Arising from Risk**

Operation of the gas transmission network in Victoria is an inherently complex business, and even more so in light of the significant structural reform undertaken in the industry, including full competition across the downstream sector. While the MSO Rules do not of themselves create any significant additional complexity, they do make existing complexity more visible. Additionally, they introduce measures that simplify risk, including such initiatives as establishing prudential requirements on trading parties to ensure minimum standards of credit worthiness, establishing efficient and low cost balancing (trading) arrangements, creating an efficient and transparent mechanism for pricing the commodity and VENCORP's transportation services, ensuring equity and fairness of treatment, and removing privately vested interest from management of the system.

It is accepted that risk, per se, is not necessarily bad where it creates appropriate incentives for greater competition and drivers for improved efficiency. The MSO Rules provide a framework that makes inherent risks more discoverable, transparent, and prices them in a competitive market-driven manner. The MSO Rules simply price gas at the underlying true value of gas and ensure that the costs of managing imbalances are minimised. In so doing, it appropriately offers Market Participants the additional advantages of being able to explore financial ways of managing their (inherent) risks as well as physical hedging strategies.

Additional uncertainty can be created from simplifications to the market design, such as single zone daily pricing and consequential need for uplift. In this case, simplification has led to uncertainty. As noted in **section 7.1.1**, the risks arising from the simplifications are not substantial and well understood at present.

As detailed previously, far from deterring new entry, new or potential new entrants to the Victorian gas market such as Energex and Ergon, and users such as Edison Mission Energy, have publicly expressed support for the Victorian spot market and market carriage concepts under the MSO Rules, in preference over contract carriage, which they have stated represents greater barriers to entry.

#### **7.6.3 Perceived Complexity Arising from Inclusion of Detail**

A further feature which may create the perception of complexity is the large amount of information made available that was previously only available internally. As in any competitive market, it is up to Market Participant to determine the extent to which they choose to invest in making use of this information. This is a business decision by the Participant.

As the Commission noted:

*"Every gas transportation system needs rules to govern all system users and reflect the realities of the networked system to which they apply. In many*



*instances, documentation specifying responsibilities and obligations of participants .... is a by-product of restructuring a vertically integrated industry into its competitive and natural monopoly components.*

*....Detail also reduces information asymmetry that may exist between well established incumbent market participants and new market participants, and therefore provides a more level playing field for competition..."<sup>88</sup>*

The extensive amount of detail incorporated in the MSO Rules should not be confused with complexity. The detail does not make the arrangements more or less complicated. The detail simply reflects the actual underlying technical complexity of the matters and makes them abundantly transparent by bringing them out into the open and documenting them.

Much of the detail comprised in the MSO Rules is relevant to every gas system in the world albeit it is usually hidden from users. The MSO Rules document this in an open and transparent manner.

The alternative of not providing this detail would be to make the terms and conditions applicable to the arrangements less understandable and thereby create uncertainty. In other words, lack of detail about terms and conditions would create far more complexity in the arrangements, and make contract negotiation considerably more complex.

The MSO Rules provide explicit, transparent documentation of standards, technical requirements, rights and obligations. The detail provided in the MSO Rules reduces information asymmetry between incumbents and new entrants, with some new entrants being the amongst the most vocal proponents of the market system.

Edison Mission Energy is a significant end user of gas as a fuel for power generation on both the East and West coasts of Australia. At an EUAA seminar in December 2001, Mr Paul Hyslop of Edison Mission Energy firmly supported the MSO Rules arrangements.<sup>89</sup> This view was re-iterated more forcefully in the submission by Edison Mission Energy to COAG's Energy Market Review:

*"To gas end users, the gas market in Australia lacks transparency. The large historical gas contracts written around Bass Strait and Cooper Basin gas are steeped in several layers of secrecy that appear to be designed to maintain a highly controlled oligopolistic arrangement and ensure that end users are unable to understand the suppliers' underlying costs. As the contractual arrangements around these two fields dominate gas supplies in Australia's southern and eastern states, end users are unable to discover the economically efficient price for gas (unlike in electricity).*

<sup>88</sup> 1998 Determination at page 47.

<sup>89</sup> This is part of Mr Paul Hyslop's response to a suggestion the Victorian market was difficult to understand.

*The only state that has gone some way to addressing this fundamental problem is Victoria, which has an operating gas pool. The Victorian Gas Market has been heavily criticised, but the most noticeable criticism has come from incumbent suppliers. From an end users perspective, the Victorian Gas Market is the most transparent and efficient gas market in operation in Australia today. In Victoria, an end user can register to purchase gas, connect and start taking it. In any other state, gaining access involves much more complex negotiations and substantial effort in terms of time and resources. End users of energy would benefit greatly if transparent gas pools were introduced throughout Australia.<sup>90</sup>*

#### **7.6.4 Complexity Arising from Technical Requirements for the PTS**

Every gas transportation system needs rules to govern all system users and reflect the physical constraints of the network. Where such matters are addressed in contracts (rather than published rules), such contracts themselves tend to be complex and it can be costly and potentially litigious for private companies to negotiate important terms on a case by case basis.

VENCorp's experience with operation and ongoing review of the MSO Rules suggests that areas of complexity simply reflect the reality of operating and trading over an open access pipeline with the physical characteristics of the Victorian PTS.

The operation of the Victorian PTS is an inherently complex matter, and is not the result of the market arrangements. The transparency of the arrangements and information provision by VENCorp simply bring an inherent complexity into the open and public view. Much of the perception about complexity arises simply from the abundance of detailed information available on both system operation and market outcomes, but abundance of information (or number of pages of supporting documents) does not substantiate claims about complexity.

VENCorp provides effective forums to deal with specific concerns, and in open consultative processes through which any viable alternative MSO Rules provisions can be tested and implemented if appropriate.

The experience to date has substantiated the efficacy of these processes, and not one formal dispute has been raised to date.

#### **7.6.5 Conclusion**

As noted in its 1998 Determination:

*"the Commission considers that the benefits from explicit documentation of standards, technical requirements and the rights and obligations of participants*

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<sup>90</sup> Edison Mission Energy submission to COAG Energy Market Review, April 2002 at page 8 (emphasis added).

*promotes transparency and thus outweighs any anti-competitive detriment arising out of the complexity of the MSOR.<sup>91</sup>*

The MSO Rules provide a transparent and proven way of dealing with the inherent complexities of transportation of gas on a large network with multiple sources of supply and complex transportation requirements, and facilitate users in managing the risks arising from these inherent complexities. As such, VENCorp submits their perceived complexity is not a barrier to entry, and this has been further demonstrated by the entry of Participants into the market since its inception and the support expressed from Market Participants on this matter.

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<sup>91</sup> 1998 Determination at page 46.

## **8 NET PUBLIC BENEFIT RESULTING FROM MSO RULES**

VENCorp submits the information detailed in **sections 6 and 7** clearly demonstrates:

- (a) the ongoing public benefits created by the MSO Rules and the spot market in providing and maintaining competition in the Victorian gas industry; and
- (b) that concerns about potential detriments from the continued authorisation of the MSO Rules are either not substantiated or are clearly outweighed by the existing and potential public benefits,

and therefore there is a substantial and significant net public benefit in providing further authorisation of the MSO Rules.

VENCorp recognises that some parties have previously opposed the MSO Rules. VENCorp points out that there is also widespread support for the MSO Rules and the benefits that they entail for both competition and economic development. A large amount of public comment has been made in support of the arrangements, and further, the regime has not only been previously endorsed by the Commission but also certified by the National Competition Council. The arrangements are clearly supporting progress in the introduction of further competition across all sectors of the industry.

The MSO Rules provide transparent arrangements for operation of the PTS and the spot market and equitable treatment of all Participants.

The process for updating the MSO Rules is also fair and transparent and does not give rise to anti-competitive outcomes or allow special treatment for some.

By 1 January 2003, the MSO Rules will have been in operation for nearly four years. The arrangements provided for under the MSO Rules and VENCorp's functions are prescribed by legislation.

Authorisation of the MSO Rules will maintain consistency with current statutory obligations. Further, they align with other regulatory instruments such as ESC licences, codes and guidelines and with VENCorp's and GasNet's revised access arrangements and the three Victorian distributors' revised access arrangements, all of which were lodged in March 2002 for effect from 1 January 2003.<sup>92</sup>

Authorisation provides certainty, while failure to authorise will result in an unknown alternative that must be developed for operation of the Victorian market and PTS. For the reasons detailed in **section 2.7** it is inappropriate to assume the market could adopt a contract carriage system and even if it did, the form and effect of such a system is unknown. Failure to authorise the MSO Rules would:

- (a) create uncertainty and risk in the existing market place;

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<sup>92</sup> All of these access arrangements are on the basis of a market carriage system and continued operation of the MSO Rules and the Victorian Gas market Retail Rules.

- (b) create the risk of unnecessary disruption to operation of the existing market through potential legal challenges;
- (c) create a significant deterrent to investment in the Victorian industry and in particular in the development of alternative sources of supply;
- (d) require wholesale revision of contracts upon which Participants have based their operations, with such revisions likely to be complicated, time consuming and expensive;
- (e) potentially lead to a contradiction with current statutory provisions and obligations;
- (f) require revision and re-submission of VENCorp's and GasNet's revised access arrangements to the Commission;
- (g) significantly impact upon and delay introduction of full retail competition in Victoria by necessitating redesign and development of many business and IT systems that are currently nearing completion, and the re-drafting of the Retail Gas Market Rules – all of this causing significant cost to the industry; and
- (h) be likely to delay the introduction of new gas fired electricity generators in Victoria with consequential risk to electricity supply for Victorian summers.

All of these factors further indicate the continuing benefit to the public of authorisation of the MSO Rules.

## **9 CONCLUSION**

Victoria currently has an effective, efficient and competitive wholesale market for gas based on the MSO Rules that have been in operation for over three years.

The MSO Rules are an essential component of the current legal and regulatory framework underpinning operation and trading through the PTS. The MSO Rules are a fundamental component of the regime by which Victoria meets its COAG obligations in respect of the implementation of national competition policy. The National Competition Council has certified the Victorian access regime, including the MSO Rules as an effective State-based access regime for the purposes of Part IIIA of the TPA<sup>93</sup>. The MSO Rules are also fundamental to VENCORP's and GasNet's revised access arrangements currently being considered by the Commission.

VENCORP submits that the Commission was correct in authorising the MSO Rules in 1998. The benefits expected at that time have been proven, while the concerns regarding potential detriments have not materialised. The MSO Rules clearly have produced net public benefits since inception.

The demonstrated public benefits arising from operation of the MSO Rules include:

- (a) efficient operation of the transmission network and market including:
  - competitive market driven response to changing supply/demand;
  - market based pricing for management of system constraints;
  - no market intervention by the system operator;
  - demand side response to high prices; and
  - low costs of market operation;
- (b) efficient medium-long term development of the gas market as evidenced by significant investment activity in new supply sources, pipelines and gas-fired generation;
- (c) promotion of price discovery through availability of spot price and market information thereby facilitating new market entry, contracting, operational business and investment decisions;
- (d) facilitation of interstate trade; and
- (e) openness and transparency thereby facilitating competition.

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<sup>93</sup> Certified by the Commonwealth Minister for Financial Services and Regulation on 29 March 2001; for full details, refer to the National Competition Council website at [www.ncc.gov.au](http://www.ncc.gov.au) under "Certification of Access Regimes".

VENCorp further submits that the existing benefits provided under the MSO Rules, together with further anticipated public benefits, will be achieved with further authorisation by the Commission and that any potential detriments are clearly outweighed by the existing and anticipated public benefits.

Failure to grant authorisation would result in these net public benefits being lost, together with the creation of uncertainty and confusion in the Victorian gas industry.

Given the:

- (a) clear net public benefits of continued authorisation of the MSO Rules;
- (b) MSO Rules will have been in operation for nearly four years by the time the Current Authorisation expires and have had ample time to be assessed;
- (c) MSO Rules form an integral part of the Victorian gas industry; and
- (d) consultative forums and review and rule change processes, have been proven to address the need for refinements and changes to the MSO Rules as the market develops,

VENCorp submits the statutory tests for authorisation of the MSO Rules in their entirety have been satisfied and requests that:

- (a) the Commission authorise VENCORP's applications; and
- (b) if the Commission is to impose a time limit upon such authorisation, that such period be ten years commencing on 1 January 2003.

## **SCHEDULE 1**

### **CATEGORIES OF PARTICIPANTS**

The gas market in Victoria involves:

- (a) VENCorp as the market and system operator;
- (b) Participants in the wholesale market; and
- (c) Customers who purchase gas from a retailer.

**VENCorp** is a statutory body established under the GIA. It is the Independent System Operator of the PTS in Victoria. It operates and administers the Victorian wholesale gas market, but does not own pipeline facilities.

**Participants** in the wholesale market include all those who own and/or operate production, storage or pipeline facilities that are connected to, or form part of, the PTS, and are required to register with VENCorp under the MSO Rules. Those who transport gas through the PTS and / or trade through the wholesale market are also required to register with VENCorp as Market Participants.

**Customers** may choose to purchase from their retailer of choice, with the introduction of retail competition, or elect to participate directly in the wholesale market. Those customers who choose to participate in the wholesale market and purchase gas for their own consumption are required to register with VENCorp as a Market Participant.

The categories of Participants are:

- (a) **Producers** undertake the extraction and/or storage and processing of natural gas for injection into the pipeline system.
- (b) **Storage Providers** have facilities that store natural gas.
- (c) **Transmission Pipeline Owners** own and maintain the gas transmission system facilities used to transport the gas between injection (e.g. production or storage facilities) and withdrawal points (e.g. another transmission pipe or storage facility) as well as to customers or the distribution networks, including GasNet.
- (d) **Interconnected Pipeline Owners** operate other transmission pipelines that connect to the PTS, e.g. interconnection with NSW.
- (e) **Distributors** own and operate the pipeline infrastructure (the distribution system) that transports the gas from the transmission pipeline to the end-use customers. Distributors need to be licensed by the ESC.
- (f) **Retailers** sell gas to end-use customers, to and from other Market Participants or producers and can transport gas through the transmission system. Retailers need to be licensed by the ESC.



- (g) **Traders** buy and sell gas to other Market Participants or producers and can also transport gas through the transmission system. Traders may not sell gas directly to end-use customers in Victoria without obtaining a retail license.
- (h) **Transmission Customers** are directly supplied with gas from the transmission system, rather than the distribution system.
- (i) **Distribution Customers** are supplied with gas from the distribution system, rather than the transmission system.

## **SCHEDULE 2**

### **CURRENT PARTICIPANTS**

AGL Energy Sales & Marketing Ltd AGL Centre 111 Pacific Highway North Sydney NSW 2060	Retailer
Albury Gas Company Level 10 81 Flinders St Adelaide South Australia 5000	Distributor
Allgas Energy Ltd Level 6 Anzac Square Bldg 200 Adelaide Street Brisbane Queensland 4000	Retailer
BHP Petroleum (Bass Strait) Pty Ltd 120 Collins St Melbourne Victoria 3000	Producer
CitiPower Pty Ltd 628 Bourke St Melbourne Victoria 3000	Retailer
Coastal Gas Australia Pty Ltd Level 2 11 Queens Rd Melbourne Victoria 3004	Interconnected Pipeline Owner
Coastal Pipelines Level 22 505 Bourke Street Melbourne Victoria 3000	Transmission Pipeline Owner
Country Energy 30 Morissett St	Trader

Queanbeyan  
NSW 2620

Duke Energy Aust Trading & Marketing Pty Ltd Level 33 Waterfront Place 1 Eagle St Brisbane Queensland 4000	Trader
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Energy Australia 570 George St Sydney NSW 2000	Retailer
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Envestra Victoria Pty Ltd Level 10 81 Flinders St Adelaide South Australia 5000	Distributor
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Ergon Energy Gas Pty Ltd Ground Floor 61 Mary Street Brisbane Queensland 4000	Retailer
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Esso Australia Resources Ltd 12 Riverside Quay Southbank PO Box 400C Melbourne Victoria 3006	Producer
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GasNet Australia (Operations) Pty Ltd 180 Greens Road Dandenong Victoria 3175	Transmission Pipeline Owner Storage Provider
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Multinet Gas Pty Ltd 422 Warrigal Road Moorabbin Victoria 3189	Distributor
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Origin Energy Petroleum Ltd 6 <sup>th</sup> Floor AMP Centre 1 King William St Adelaide	Producer
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**South Australia 5000**

Origin Energy (VIC) Pty Ltd  
Level 11  
AMP Centre  
50 Bridge St  
Sydney  
NSW 2000

Retailer

Pulse Energy Pty Ltd  
Level 8  
IBM Tower  
60 City Road  
Melbourne  
Victoria 3000

Retailer

TXU Networks (Gas) Pty Ltd  
Level 17  
452 Flinders St  
Melbourne  
Victoria 4000

Distributor

TXU Pty Ltd  
Level 33  
385 Bourke St  
Melbourne  
Victoria 3000

Retailer

Western Underground Gas Storage Pty Ltd  
Level 4  
Atrium Tower  
459 Collins St  
Melbourne  
Victoria 3000

Storage Provider

Visy Paper Pty Ltd  
13 Reo Cr  
Campbellfield  
Melbourne  
Victoria 3061

Distribution Customer

**SCHEDULE 3**

**CURRENT MSO RULES**

**(attached as a separate document)**

## SCHEDULE 4

### PROPOSED CHANGES TO MSO RULES FOR VENCORP'S REVISED ACCESS ARRANGEMENT

Proposals are based on MSO Rules assuming current operational (v 16) with changes for FRC, as authorised by ACCC but not currently enacted, included. Changes are change marked<sup>94</sup>.

#### 1.1.3 The regulatory framework

"Diagram"

Delete the text box "Tariff Order" from the diagram.

#### 1.2.1 Obligations of VENCorp

- (k) ~~For the purposes of the *Tariff Order*, the obligations and functions of VENCorp as described in this clause 1.2.1, are the *tariffed VENCorp services*.~~

#### 2.6 Market Fees

- (a) VENCorp may charge, and *Participants* must pay, *market fees* in accordance with this clause 2.6.
- (b) Subject to clauses 2.6(d) to (h), *market fees*, which are charged for *tariffed VENCorp services* must be determined by the Board of Directors of VENCorp, and approved by the *Regulator*, in respect of ~~each financial year~~ in accordance with the ~~*Tariff Order*~~*VENCorp's access arrangement*.
- (c) Unless otherwise approved by the *Regulator*, each *Participant* must pay to VENCorp *market fees* in accordance with this clause 2.6(c):
- (1) each *Market Participant* must pay a registration fee ~~tariff~~tariff determined in accordance with the ~~*Tariff Order*~~*with VENCorp's access arrangement* ~~for every day or part of a day during which that Market Participant is registered under clause 2.1;~~
  - (2) each *Market Participant* who withdraws gas from the *transmission system* at a *system withdrawal point* or injects gas into the *transmission system* at a *system injection point* must ~~pay a metering fee associated with a "transmission supply point" as defined in the *Tariff Order* and as determined in accordance with the *Tariff Order*,~~
  - (3) ~~each *Retailer* or~~ whose *Customers* are connected to a *transmission delivery point* at which there is a *metering installation* from which VENCorp is responsible for collecting *metering data* must ~~pay, in respect of each such *metering installation* a metering fee associated with a "transmission supply point"~~meter data management tariff as

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<sup>94</sup> A strikethrough indicates text that has been deleted and underscoring indicates text that has been inserted.

defined in the *Tariff Order* and as determined in accordance with the *Tariff Order* VENCorp's access arrangement;

- (4) each *Retailer Market Participant* who is connected to a *distribution delivery point* or whose *Customers* are connected to a *distribution delivery point* at which there is a *metering installation* from which *VENCorp* is responsible for collecting *metering data* must pay, in respect of each such *metering installation* a metering fee associated with a "distribution supply point" as defined in the *Tariff Order* and as determined in accordance with the *Tariff Order*;
- (5) ~~each *Distribution Customer* who is a *Market Participant* and who is connected to a *distribution delivery point* at which there is a *metering installation* from which *VENCorp* is responsible for collecting *metering data* must pay, in respect of that *metering installation*, a metering fee associated with a "distribution supply point~~ meter data management tariff as defined in the *Tariff Order* and as determined in accordance with the *Tariff Order* VENCorp's access arrangement;
- (5a) with the exception of data provided to *VENCorp* for settlement in accordance with the *Retail Gas Market Rules*, where gas quantities are provided to *VENCorp* by an *Allocation Agent* or otherwise derived by *VENCorp* for the purpose of settlement, the *Market Participant* for which the information is required shall be deemed to have a *metering installation* for the purpose of this clause 2.6.
- (6) each *Retailer Market Participant* who withdraws gas at a *tariff V withdrawal point* or who sells gas to *Customers* who withdraw gas at a *tariff V withdrawal point* in a financial year must pay a commodity charge determined in accordance with the *Tariff Order* for each GJ of gas withdrawn by those *Customers* at such *tariff V withdrawal point* and sold by that *Retailer* to those *Customers* during that financial year;
- (7) ~~each *Market Customer* who withdraws gas at a *tariff V withdrawal point* must pay a "tariff V commodity charge~~ tariff determined in accordance with the *Tariff Order* for each GJ of gas withdrawn by that *Market Customer* at that *tariff V withdrawal point* during each financial year VENCorp's access arrangement;
- (8) each *Retailer Market Participant* who withdraws gas at a *tariff D withdrawal point* or who sells gas to *Customers* who withdraw gas at a *tariff D withdrawal point* in a financial year must pay a commodity charge determined in accordance with the *Tariff Order* for each GJ of gas withdrawn by those *Customers* at such *tariff D withdrawal point* and sold by that *Retailer* to those *Customers* during that financial year;
- (9) ~~each *Market Customer* who withdraws gas at a *tariff D withdrawal point* must pay a "tariff D commodity charge~~ tariff determined in accordance with the *Tariff Order* for each GJ of gas withdrawn by that *Market Customer* at that *tariff D withdrawal point* during each financial year VENCorp's access arrangement; and
- (9a) For the purpose of applying "tariff D commodity tariffs" and "tariff V commodity tariffs", relevant *metering installations* must be assigned to

tariff D or tariff V in accordance with the provisions of any regulatory instrument that may be applicable from time to time.

- (9b) Subject to (9c), where there is no regulatory instrument applicable then, for the purpose of applying "tariff D commodity tariffs" and "tariff V commodity tariffs":

(A) a relevant metering installation shall be assigned to tariff D where:

(i) 10 GJ or more of gas is withdrawn in any hour, or

(ii) 10,000 GJ or more of gas in total is withdrawn,

based on metering data available for the past 12 months, or where 12 months metering data is not available then based on a reasonable estimation for the next 12 month period, or

(B) If a metering installation is not assigned to tariff D then the metering installation must be assigned to tariff V.

- (9c) A Transmission Pipeline Owner or a Distributor, as the case may be, may notify VENCORP that an assignment of tariff D or tariff V is to be other than as prescribed above.

- (10) each Market Participant must pay a ~~system security gas storage~~ charge described as a "system security tariff" charge in the Tariff Order and determined in accordance with the Tariff Order, in respect of each GJ of gas withdrawn from the transmission system by that Market Participant VENCORP's access arrangement.

- (ca) VENCORP may, in its absolute discretion, apply to the Regulator at any time for a variation to the reference tariffs prescribed in VENCORP's access arrangement.

- (d) VENCORP must, before submitting its an annual application statement to the Regulator for approval of Transmission Meter Data Management Tariffs, Distribution Meter Data Management Tariffs and System Security Tariffs for tariffed VENCORP services for the next financial year and must do so in accordance with clause 6.1(a)(2) of the Tariff Order, produce an initial report setting out VENCORP's access arrangement:

- (da) Before submitting its annual application to the Regulator under clause 2.6(d) for approval VENCORP must produce an initial report setting out:

- (1) VENCORP's budgeted expenditures and budgeted revenues for that regulatorythe next financial year;
- (2) the amount of proposed-market fees in respect of each of the tariffed VENCORP services in respect of which market fees are proposed to be charged for the next financial year in respect of Transmission Meter Data Management Tariffs, Distribution Meter Data Management Tariffs and System Security Tariff tariffed VENCORP services;
- (3) the method used in determining the amount of proposed market fees in respect of each of VENCORP's activities referred to in clause 2.6(da)(2)



- including but not limited to *VENCorp's* estimated costs and expenses associated with those activities;
- (4) other fee structures and fee amounts which are appropriate for comparison purposes; and
- (5) an assessment of the extent to which the proposed *market fees* comply with the principles set out in clause 8.1 of the *Access Code*.
- (e) *VENCorp* must provide a copy of the initial report to:
  - (1) the *Regulator* on completion of the report; and
  - (2) *Participants* and interested persons on request.
- (f) *VENCorp* must invite *Participants* and interested persons to make submissions in relation to the initial report and must consider any such submissions received up to ten *business days* after the initial report is made available to *Participants* and interested persons under clause 2.6(e)(2).
- (g) *VENCorp* must prepare a final report which summarises:
  - (1) submissions received under clause 2.6(f); and
  - (2) the process of consultation undertaken by *VENCorp* in relation to preparation of the final report.
- (h) *VENCorp* must provide a copy of the final report to the *Regulator* at the time of submitting its annual statement to the *Regulator* for approval in accordance with clause 6.1(a)(2) of the *Tariff Order* *VENCorp's access arrangement*.

## 2.7 Previous Financial Year Report

- (a) *VENCorp* must, by no later than two months after the end of each *financial year*, prepare a report setting out:
  - (1) *VENCorp's* budgeted and actual expenditures and budgeted and actual revenues in respect of each of the *tariffed VENCorp services* in respect of the previous *financial year* including, but not limited to:
    - (A) "system security";
    - (B) collection, storage and processing of *metering data* and billing and *settlement of market* transactions; and
    - (C) costs of operating the dispute resolution process under clause 7.2;
  - (2) an explanation of any significant variation between budgeted and actual expenditures and budgeted and actual revenues in respect of the previous *financial year*, and
  - (3) contributions made to and payments made from the *participant compensation fund*; and
  - (4) *VENCorp's* budgeted expenditures in respect of tariffed *VENCorp* services over the term of *VENCorp's* corporate planning process with reference to the *access arrangement* forecast expenditure.

in respect of the previous financial year.

- (b) VENCorp must provide a copy of the report prepared under clause 2.7(a) to:
- (1) the *Regulator* on completion; and
  - (2) *Participants* and interested persons on request.

### 5.3.1 Agreement for provision of transportation services

- (a) Prior to ~~the commencement date~~, gas being withdrawn from that component of the transmission system owned by a Transmission Pipeline Owner, VENCorp and ~~a that Transmission Pipeline Owner~~ must enter into a *service envelope agreement*, and thereafter must at all times ensure that there is a valid *service envelope agreement* in force between them, under which the *Transmission Pipeline Owner* agrees, amongst other things, to provide to VENCorp gas transportation services and *pipeline capacity* by means of the *pipelines* of that *Transmission Pipeline Owner* which form part of the *transmission system* on terms which are not inconsistent with:
- (1) the *access arrangement*, if any, of the *Transmission Pipeline Owner*; and
  - (2) ~~the Tariff Order, if applicable.~~ VENCorp's access arrangement.

### 5.3.4 Subsequent allocations and re-allocations of authorised MDQ

- (g) All monies received by VENCorp from an auction conducted in accordance with clause 5.3.4(e)(2) are to be used by VENCorp to offset its costs for the next *financial year*. ~~calculated in accordance with the Tariff Order.~~

## 11 Glossary

<b>Access Code</b>	The <u>National Third Party Access Code for Natural Gas Pipeline Systems</u> , as in force in Victoria pursuant to the <u>Gas Pipelines Access (Victoria) Act 1988 (Vic)</u> . <del>Victorian Third Party Access Code for Natural Gas Pipeline Systems established under the Gas Industry Act, and where applicable, subject to sections 24A and 24B of the Gas Pipelines Access (Victoria) Act 1998, the new Access Code as more particularly described in section 24A of that Act.</del>
<b>market fees</b>	The fees payable by a <i>Market Participant</i> determined in accordance with clause 2.6 being the tariffs for <i>tariffed VENCorp services</i> .
<b><u>regulatory instrument</u></b>	<u>Any law, statute, regulation, code, rule, order, guideline, or sub-code, regulating the gas industry in Victoria from time to time.</u>

<b>tariff D withdrawal point</b>	A <i>system withdrawal point</i> to which transmission delivery tariff D is assigned or a <i>distribution delivery point</i> to which distribution tariff D is assigned under <del>the Tariff Order</del> <u>an applicable regulatory instrument</u> .
<b>tariff V withdrawal point</b>	A <i>system withdrawal point</i> to which transmission delivery tariff V is assigned or a <i>distribution delivery point</i> to which distribution tariff V is assigned under <del>the Tariff Order</del> <u>an applicable regulatory instrument</u> .