Final Determination

Application by Victorian Energy Networks Corporation for authorisation of the Market and System Operations Rules

Date: 18 December 2002

Authorisation Nos:
A90831
A90832
A90833

File No:
C2002/582

Commissioners:
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Abbreviations

AGA	Australian Gas Association
AGL	Australian Gas Light Company
AMDQ	Authorised Maximum Daily Quantity
AMDQ credit	Authorised Maximum Daily Quantity credit
CoAG	Council of Australian Governments
Code	National Third Party Access Code for Natural Gas Pipeline Systems
Commission	Australian Competition and Consumer Commission
DNRE	Department of Natural Resources and Environment
Duke	Duke Energy Australia Pty Ltd
EAG	Energy Action Group
EAPL	East Australian Pipeline Limited
Energex	Energex Retail Pty Ltd
EoD Linepack	End of Day Linepack
ESC	Essential Services Commission, Victoria
Esso	Esso Australia Pty Ltd
EUAA	Energy Users Association of Australia
GasNet	GasNet Australia (Operations) Pty Ltd
GMCC	Gas Market Consultative Committee
inc/dec	increment/decrement
KPI	Key performance indicator
LAMA	Longford Allocation Master Agreement
LNG	Liquefied Natural Gas
MAPS	Moomba to Adelaide Pipeline System
MSOR	Market and System Operations Rules
NEC	National Electricity Code
NECA	National Electricity Code Administrator

NEM	National Electricity Market
NEMMCo	National Electricity Market Management Company
PCF	Participant Compensation Fund
PJ	Petajoule
PTS	Principal Transmission System
SSNIP	Small but significant non-transitory increase in price
TJ	Terajoule
TPA	Trade Practices Act (1974)
TXU	TXU Australia Pty Ltd
Tribunal	Australian Competition Tribunal
UAFG	Unaccounted for gas
UGS	Underground Gas Storage facility
VENCorp	Victorian Energy Networks Corporation
VoLL	Value of Lost Load
WTS	Western Transmission System

Glossary

access arrangement	an arrangement for third party access to a pipeline provided by a service provider and approved by the relevant regulator in accordance with the Code
ancillary payments	additional payments made to market participants to compensate when transmission constraints or surprises result in them being disadvantaged by a uniform, daily spot price
augmentation	the process of upgrading the capacity or service potential of a transmission (or a distribution) pipeline
bid price	the price specified by a market participant in an inc/dec offer
Covered Pipeline	pipeline to which the provisions of the Code applies
dec offer	an offer by a market participant to decrease its scheduled withdrawal of gas from the system so that gas becomes available to other users
distribution	the transport of gas over a combination of high pressure and low pressure pipelines from a city gate to the usage points of various customers
EoD linepack	end of day linepack; a financial instrument to allow market participants to hedge against the day-to-day variation in gas prices
extension	extending a pipeline to provide supply of gas to areas not supplied with gas prior to extending the pipeline
firm transport	a transport service which guarantees to provide gas at the contracted or reserved level every day of the year
GJ	Gigajoule, equal to one thousand million joules
inc offer	an offer by a market participant to request, for a specified price, an amount of gas surplus to its own scheduled requirement to be injected into the system under its contract with its supplier so that the overall supply of gas to the system is increased
injection	the physical injection of gas into the gas transmission system
Interconnect	the pipeline connecting the PTS at Barnawatha to the EAPL transmission system in New South Wales at Culcairn
load factor	the ratio between average and peak daily load
locational hourly pricing	a system for determining the price of gas under which the price is determined for a period of less that 24 hours and for several locations within the area serviced by the pipeline

linepack	the amount of gas in a pipeline at any point in time
market commencement	market commencement is the commencement date as prescribed in clause 1.1.4 of the MSOR (or as amended)
market participant	a participant who is entitled to participate in the market governed by the MSOR by submitting nominations and inc/dec offers in accordance with the MSOR
natural gas	a naturally occurring hydrocarbon composed of between 95 and 99 per cent methane and the remainder ethane
nomination	a nomination by a market participant in respect of a quantity of gas to be injected into or withdrawn from the transmission system on a gas day
peak period	the period of 1 June to 30 September each year
PJ	Petajoule, equal to one million GJ
scheduling	the process of scheduling nominations and inc/dec offers which VENCorp is required to carry out in accordance with the MSOR for the purpose of balancing gas flows in the transmission system and maintaining the security of the transmission system
service envelope agreement	an agreement between VENCorp and a transmission pipeline owner under which the latter agrees to make pipeline services and gas transportation capacity available to VENCorp for a specified time period
single zone daily pricing	a mechanism for determining the price of gas under which the price is determined for a 24 hour period, and a single price is determined for the entire area serviced by the pipeline
storage facility	a facility for the storage of gas, including the LNG storage facility and the WUGS
surprises	events which can occur within the day for which, in order to operationally balance the system, VENCorp may need to change the schedule of gas injections and/or withdrawals issued at the start of the gas day
tariff D customer	daily metered customer
Tariff Order	the Tariff Order regulates the pricing of tariffed services and excluded services provided by persons within the Victorian gas industry
tariff V customer	non-daily metered customer
third party access	access to facilities by independent parties
TJ	terajoule, equal to one thousand GJ

transmission	long haul transportation of gas via high pressure pipelines

Executive summary

On 20 May 2002 the Australian Competition and Consumer Commission (the Commission) received applications for the renewal of authorisations (numbers: A90831, A90832 and A90833) of the Market and System Operations Rules (the MSOR). Victorian Energy Networks Corporation (VENCorp) submitted the applications under Part VII of the *Trade Practices Act 1974* (the TPA) together with a supporting submission. VENCorp has applied for a ten-year period of authorisation commencing 1 January 2003.

This *Final Determination* outlines the Commission's analysis and views on the applications for re-authorisation of the MSOR.

The Commission received three applications from VENCorp for re-authorisation under:

- section 88(1) of the TPA for an authorisation to make and give effect to any contract, arrangement or understanding, constituted by or under the MSOR, 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;[1]

- section 88(1) of the TPA for an authorisation to make and give effect to any contract, arrangement or understanding, constituted by or under the MSOR, 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 (including any deemed lessening of competition through price fixing arrangements within the meaning of section 45A of the TPA);[2] and

- section 88(8) of the TPA for an authorisation to make and give effect to the MSOR to the extent that making the MSOR or giving effect to a provision of the MSOR, involves engaging in conduct that would or might constitute the practice of exclusive dealing within the meaning of section 47 of the TPA.[3]

Market Definition

The Commission has largely maintained the market definition it adopted in its 1998 *Determination*. The Commission considers the relevant market to be:

- product market: gas;

- geographic market: emerging south east Australian market, with some constraints on gas entering Victoria from basins outside Bass Strait; and

- functional markets: gas wholesale and gas transmission.

Counterfactual

In its 1998 *Determination* the Commission accepted unanimous submissions from interested parties that the counterfactual was contract carriage.

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1 A90831, Form A: Exclusionary provisions, VENCorp 2002, 20 May 2002.

2 A90832, Form B: Agreements affecting competition, VENCorp 2002, 20 May 2002.

3 A90833, Form C: Exclusionary dealings, VENCorp 2002, 20 May 2002.

On this occasion VENCorp and interested parties expressed strong divergences of opinion on this issue. Most interested parties now consider that the counterfactual is another form of market carriage. This is because market carriage has Victorian government support, and also because some interested parties consider that contract carriage would not work in Victoria.

The Commission considers there is uncertainty as to what the counterfactual is. Therefore it is logical to postulate a range of potential future situations. The relevant counterfactual could either be:

- the markets for wholesale supply and transmission of gas incorporating some variation on the market carriage model currently embodied in the MSOR; or
- the markets for wholesale supply and transmission of gas incorporating a variation of contract carriage, taking into account the effects of the introduction of the reforms and the particularities of the Victorian gas industry; or
- a combination of these.

Public Benefits

The Commission considers that significant public benefit has flowed, and additional benefits are likely to flow in future, from the MSOR.

The MSOR are instrumental to the implementation of market carriage in Victoria. Market carriage, with an independent systems operator and a spot market to settle imbalances, represents an important component of a package of reforms implemented by the Victorian Government, which aimed to create competitive natural gas wholesale and retail markets in Victoria.

It is anticipated that these markets will develop further. The introduction of new sources of gas and the commencement of full retail contestability should assist this process. As the market develops the benefits of the MSOR and market carriage generally should become clearer.

The Commission is satisfied that there are tangible benefits presently flowing from the MSOR. These are:

- efficient gas balancing;
- improved network services;
- efficient medium and long term development of the gas market;
- openness and transparency of the MSOR;
- promotion of price discovery;
- the maintenance of consistency with current arrangements; and
- the facilitation of retail competition.

Anti-competitive Detriments

The Commission considers that several aspects of the MSOR have the potential to detract from the public benefit associated with the MSOR. These are:

- the provisions relating to the liability of interested parties;
- the ramifications of single zone daily pricing arrangements;
- the current arrangements relating to transmission rights;
- the complexity of the MSOR; and
- the need for greater end user representation.

In relation to the first of these, the Commission has required adjustments to the MSOR as a condition of authorisation. In relation to the second and fifth, the Commission has not imposed conditions of authorisation, but has recommended that VENCorp take action to address these issues. The third issue, transmission rights, is likely to be addressed in the first instance by way of changes to the current pricing mechanism. If these do not occur, however, the Commission has recommended that VENCorp review this issue. The Commission considers that the fourth, complexity of the MSOR, is necessary and justified in the circumstances.

Period of authorisation

VENCorp has applied for authorisation for ten years. Five interested parties strongly supported authorisation for ten years while four were strongly opposed.

The Commission believes that authorisation of the MSOR should be for ten years. This is primarily because of the statutory review, which could result in substantial changes to VENCorp and the MSOR. If authorisation were granted for a period of five years, the subsequent authorisation application would need to be assessed during 2007. Such an assessment could be superfluous given significant changes could be implemented and would possibly need to be authorised.

If material changes occur throughout this period authorisation can be revoked under section 91B of the TPA. Additionally, the MSOR have effective rule change processes that can be used to amend the MSOR, should industry developments during the ten-year period necessitate this.

Net public benefits and detriments

Although the Commission considers that some aspects of the proposed arrangements and conduct contained in the MSOR may lessen competition and/or constitute an exclusionary provision or exclusive dealing, it considers that subject to the conditions listed in section 8 of this *Final Determination*, in all the circumstances the MSOR are likely to result in:

- a benefit to the public which outweighs the potential detriment from any lessening of competition that has resulted from the operation of the MSOR, or is likely to result from the continued operation of the MSOR; and
- such a benefit to the public that the MSOR should be allowed.

Final Determination

The Commission grants authorisation for applications A90831, A90832 and A90833 subject to the following conditions:

C6.1 It is a condition of authorisation that clause 3.1.13(d)(1) be amended to provide, relevantly:

due to a technical fault or failure or *force majeure event* which was outside the *Market Participant's* control.

This clause is to be read subject to the obligations placed on *Participants* by clause 6.7.2.

VENCorp may comply with this amendment by adopting either Option 1 or Option 2.

Option 1 - By amending the MSOR to reflect condition of authorisation C6.1 by no later than 8 months after this *Final Determination* comes into effect: or

Option 2 - By agreeing to an alternative wording with Esso that addresses Esso's concerns in relation to situations generally considered to be *force majeure* situations, and submitting the proposed change to the GMCC within 5 months of this *Final Determination* coming into effect. The proposed change must be approved by the GMCC and VENCorp's Board of Directors within a further three months.

If Option 2 is pursued but not completed within 8 months of this *Final Determination* coming into effect, then condition C6.1 must be implemented without delay.

C7.1 Authorisation of the MSOR is granted until 31 December 2012.

This *Final Determination* is made on 18 December 2002. If no application for review is made to the Australian Competition Tribunal, it will come into effect on 8 January 2003. If an application for review is made to the Tribunal, the *Final Determination* will come into effect:

- where the application is not withdrawn – on the day on which the Tribunal makes a determination on the review; or
- where the application is withdrawn – on the day on which the application is withdrawn.

1. Introduction

On 20 May 2002 the Australian Competition and Consumer Commission (the Commission) received applications for the renewal of authorisations (numbers: A90831, A90832 and A90833) of the Market and System Operations Rules (the MSOR). The Victorian Energy Networks Corporation (VENCorp) submitted the applications under Part VII of the *Trade Practices Act 1974* (the TPA) together with a supporting submission. VENCorp has applied for a ten-year period of authorisation commencing 1 January 2003.

This *Final Determination* outlines the Commission's analysis and views on the applications for re-authorisation of the MSOR.

This section briefly describes the applications and parties to the applications for re-authorisation. Section two outlines the public consultation process carried out by the Commission. Section three provides background information on VENCorp, the MSOR and the Victorian gas transmission system. The statutory assessment criteria and approach are documented in section four. Section five discusses the market definition and counterfactual pertaining to the MSOR. Section six assesses the public benefits and anti-competitive detriments submitted by VENCorp and interested parties. The length of authorisation is discussed in section seven. Section eight summarises the net public benefits and detriments likely to flow from the MSOR. Section nine sets out the Commission's *Final Determination*.

1.1 The applications

VENCorp seeks authorisation for the whole of version 20 of the MSOR. Version 20 of the MSOR incorporates minor changes from the version originally submitted for authorisation on 20 May 2002. Those amendments relate to amendments required to comply with the Commission's *Final Decision* in relation to VENCorp's revised access arrangement.

The Commission received three applications from VENCorp for re-authorisation under:

- section 88(1) of the TPA for an authorisation to make and give effect to any contract, arrangement or understanding, constituted by or under the MSOR, 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;[4]

- section 88(1) of the TPA for an authorisation to make and give effect to any contract, arrangement or understanding constituted by or under the MSOR, 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 (including any deemed lessening of competition through price fixing arrangements within the meaning of section 45A of the TPA);[5] and

- section 88(8) of the TPA for an authorisation to make and give effect to the MSOR to the extent that making the MSOR or giving effect to a provision of the MSOR, involves

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4 A90831, Form A: Exclusionary provisions, VENCorp 2002, 20 May 2002.

5 A90832, Form B: Agreements affecting competition, VENCorp 2002, 20 May 2002.

engaging in conduct that would or might constitute the practice of exclusive dealing within the meaning of section 47 of the TPA.[6]

1.2 Parties to the applications

The applications for re-authorisation 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 MSOR will be between the applicant and a participant (as defined in the MSOR) or between participants.

As such, the applicant has submitted that the authorisation should extend to existing participants, future participants and all contracts, arrangements and understandings constituted by or under the MSOR. This is consistent with VENCorp's application for authorisation in 1997 and is provided for under the following provisions of the TPA:

- section 88(6), which provides that an authorisation granted to a person to make or give effect to a contract, arrangement or understanding has effect as if it were also an authorisation to every other person named or referred to in the application for authorisation; and

- section 88(10), which provides that an authorisation granted to make or give effect to a contract, arrangement or understanding may apply to another person who becomes a party to the contract, arrangement or understanding subsequently; and

- section 88(13), which provides that an application for authorisation in relation to a particular contract or proposed contract can be expressed to be also an application for other contracts that are similar in terms to the first-mentioned contract, and if so, the Commission may grant a single authorisation or separate authorisations.

VENCorp has listed the current participants in revised schedule 2 of its applications and therefore under section 88(6) any authorisation granted may apply to those participants. Under section 88(10) any authorisation may also apply to future participants.[7]

In accordance with section 88(13), VENCorp has requested that any authorisation is expressed as a single authorisation and that it includes contracts between VENCorp and participants and between participants that are constituted by giving effect to the MSOR.

The Commission considers that it is appropriate for the benefit of authorisation granted to extend to participants, future participants and to contracts that are entered into to give effect to the MSOR.

1.3 VENCorp's application for interim authorisation

VENCorp applied to the Commission for interim authorisation on 13 November 2002. This interim authorisation was sought for the a revised version of the MSOR which included changes to the MSOR which were necessary as a result of the Commission's *Final Decision* in relation to VENCorp's access arrangement for the PTS of 13 November 2002.

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6 A90833, Form C: Exclusionary dealings, VENCorp 2002, 20 May 2002.

7 The revised schedule 2 was submitted to the Commission on 10 December 2002.

Interim authorisation was granted on 11 December 2002 until VENCorp's application for the authorisation is finalised.

2. Public consultation process

The Commission has a statutory obligation under the TPA to follow a public process when assessing an application for authorisation.

On 20 May 2002 the Commission received applications for the re-authorisation of the MSOR for the Victorian natural gas transmission system. On 7 June 2002, the Commission released an *Issues Paper* inviting submissions from interested parties on the public benefit claimed and also in relation to the likely effect on competition of the MSOR.

Eleven parties made submissions on the re-authorisation application. A list of these parties is in Appendix A and copies of their submissions have been placed on the Commission's public register as well as on its website (http://www.accc.gov.au).

The Commission issued a *Draft Determination* on 16 October 2002 proposing to grant authorisation for 10 years. The Commission invited the applicant and other interested persons to notify it within 14 days, whether they wished the Commission to hold a conference in relation to the *Draft Determination*.[8] The Energy Action Group, with the support of the Energy Users Association of Australia, so notified the Commission on 25 October 2002.

Following the release of the *Draft Determination*, the applicant and interested parties were given the opportunity to make further submissions to the Commission. No further submissions were made.

The pre-determination conference was held on 21 November 2002 in Melbourne. Eighteen interested parties attended the conference.

The applicant and interested parties were given a further opportunity to make submission in relation the issues raised at the conference. Three submissions were received and are listed in Appendix A. Copies of their submissions have been placed on the Commission's public register as well as on its website (http://www.accc.gov.au).

The Commission has taken into account issues raised at the conferences and in subsequent submissions. This document represents the Commission's final determination in relation to the authorisation applications. A person dissatisfied with this *Final Determination* may apply to the Australian Competition Tribunal for review within 21 days.

[8] For the purposes of the pre-decision conference, an interested person is a person who has notified the Commission in writing that the person, or a specified unincorporated association of which the person is a member, claims to have an interest in the application and the Commission is of the opinion that the interest is real and substantial.

3. Background

On 19 August 1998 the Commission issued a *Determination* (1998 Determination) granting authorisation for chapters 2 to 6 of the MSOR.

Authorisation was subject to conditions, including that it be until 1 January 2003. The 1998 Determination also required that several amendments be made to the MSOR, and stipulated a number of reviews to be conducted by VENCorp.[9] These reviews and amendments have taken place as required.

Since VENCorp's initial application in 1997, it has made 15 applications for amendment to the MSOR. This includes the recent minor variations to the MSOR authorised by the Commission on 31 July 2002, which were made in preparation for the introduction of full retail contestability in Victoria. The current application for authorisation is for the MSOR as amended, including the most recent rule changes.

3.1 VENCorp's Role and Functions

VENCorp is a statutory authority owned by the Victorian State Government. It has operational, planning and development roles in relation to both the gas and electricity industries. VENCorp's functions in the gas industry include the following:

- systems operator for the Principal Transmission System[10] (PTS) and administrator and developer of the Victorian wholesale gas market under the *Gas Industry Act 2001* (Vic) (the Gas Industry Act);
- operational and communications responsibilities during gas emergencies; and
- facilitating the development, implementation and operation of full retail contestability in Victoria.

VENCorp's functions as systems operator and administrator of the wholesale market are funded by market participants. VENCorp's tariffs are regulated by the Commission under the *National Third Party Access Code for Natural Gas Pipeline Systems* (the Code). VENCorp's tariffs are currently set in accordance with its initial access arrangement, which was approved by the Commission on 16 December 1998 and remains in force until 31 December 2002. VENCorp submitted a proposed revised access arrangement to the Commission on 28 March 2002. That proposed access arrangement is scheduled to commence on 1 January 2003. The Commission issued a *Draft Decision* on VENCorp's proposed access arrangement on 14 August 2002.

VENCorp is governed by an independent Board of Directors who are appointed by the Victorian Government. The Board has a Chairperson and not more than nine other directors.

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9 ACCC 1998 Determination, Section 16.

10 In its *Draft Decision* for GasNet's Access Arrangement, 14 August 2002, the Commission accepted VENCorp's argument that there is no substantive reason to adopt a new term to describe the PTS.

3.2 The MSOR

The MSOR govern the operation of the PTS and the wholesale gas market. The rules are a legal instrument which were initially made under section 48N of the *Gas Industry Act 1994* (Vic) and are now governed by Part 4 of the Gas Industry Act.

The MSOR came into force on 2 February 1999, except the provisions dealing with the establishment of the wholesale spot market, which came into force on 15 March 1999.

The MSOR require a service envelope agreement between the owner of the PTS and VENCorp. Under the service envelope agreement the owner makes all of its transmission capacity on the PTS available to VENCorp. The service envelope agreement was entered into between VENCorp, Transmission Pipelines of Australia and Transmission Pipelines of Australia (Assets) in 1998 and has a termination date of 11 December 2007, although the MSOR require that a service envelope agreement remain in place at all times.

Clause 1.1.2 of the MSOR states that the purpose of the MSOR is to:

- provide an efficient, competitive and reliable wholesale gas market;
- regulate the operation and administration of the wholesale market for natural gas;
- regulate the activities of parties using the PTS and the wholesale gas market;
- regulate the operation of the PTS by VENCorp in a manner which:
  - minimises threats to system security; and
  - enables access to the PTS and wholesale gas market; and
- facilitate VENCorp's performance of its functions.

The MSOR relate to the following:

- participation in the wholesale gas market;
- requirements for participation (such as prudential requirements);
- nomination and bidding processes;
- scheduling of gas;
- setting the wholesale spot market price;
- management of system security;
- dispute resolution; and
- rule change process.

4. Statutory test

This section outlines the criteria set out in the TPA that the Commission must use to assess the applications for authorisation.

VENCorp has applied for authorisation under sections 88(1) and 88(8) of the TPA. Authorisation provides immunity against actions for breach of the TPA. Authorisation granted under sections 88(1) and 88(8) of the TPA provides immunity to parties to an authorisation for contraventions of sections 45 and 47 respectively.

Section 45 of the TPA prohibits the making of, or giving effect to, a contract, arrangement or understanding containing provisions:

- which are exclusionary; or
- which have the purpose or effect (or likely effect) of substantially lessening competition (an arrangement that fixes prices is deemed under section 45A of the TPA to have the purpose or effect of substantially lessening competition).

Section 47 prohibits exclusive dealing. Generally this involves:

- the supply of goods or services on the condition that the purchaser will not acquire goods or services from a competitor; or
- the acquisition of goods or services on the condition that the supplier will not supply goods and services to a third party; provided that
- the conduct has the purpose or effect (or likely effect) of substantially lessening competition.

The Commission must not grant an authorisation:

- under section 88(1) (excluding an exclusionary provision) or section 88(8) (excluding conduct to which section 47(6) or section 47(7) applies) unless it is satisfied in all the circumstances that:
  - the provisions or conduct would result (or be likely to result) in a benefit to the public; and
  - that benefit would outweigh the detriment to the public constituted by any lessening of competition that would result (or be likely to result) from the proposed contract, arrangement, understanding or conduct (section 90(6));
- under section 88(1) (in respect of an exclusionary provision) or under section 88(8) (in respect of conduct to which section 47(6) or section 47(7) applies) unless it is satisfied in all the circumstances that the proposed provision or conduct would result (or be likely to result) in such a benefit to the public that the proposed contract, arrangement, understanding or conduct should be allowed (section 90(8)).

The tests are, for all practical purposes, the same:

- the Commission is required to compare 'the future with the relevant conduct and the future without the relevant conduct';

- the concept of public benefit is given a wide ambit, namely 'anything of value to the community generally, any contribution to the aims pursued by the society';
- similarly, public detriment refers to 'any impairment to the community generally, any harm or damage to the aims pursued by the society including as one of its principle elements the achievement of the goal of economic efficiency'; and
- the definition of the market is relevant to the identification of the benefit and the detriment.

The Commission is required to make a determination granting the authorisation (although the authorisation may be subject to conditions) or dismissing the application.

5. Competition Issues

5.1 Market Definition

An important step in assessing any application for authorisation is to define the market in which the proposed conduct will take place. The Commission is then able to assess the likely benefit and detriment of the proposed conduct within the market defined.

In seeking authorisation for the MSOR, VENCorp has sought authorisation for its own activities as systems operator, and for the activities of market participants who use the spot market, or who are otherwise engaged in Victoria's wholesale gas market.

VENCorp's responsibilities, as set out in the MSOR, include acting as systems operator for the PTS, and operating Victoria's spot market. The MSOR facilitate trade in wholesale gas.

Markets are generally defined in product, geographic and functional space.

In general terms, markets must always be defined with a view to the purpose of doing so.[11] The purpose in this instance is to assess the public benefit and anti-competitive detriment likely to flow from the MSOR. A market can be defined as the smallest area over which a hypothetical monopolist (or monopsonist) could exercise a significant degree of market power. It is clear from section 4E of the *Trade Practices Act* that all actual or potential substitutes for the good or service in question should be included in the market.

This concept of substitutability was discussed by the Australian Competition Tribunal (the Tribunal) in *Re Queensland Co-operative Milling Association Ltd and Defiance Holdings Ltd* (1976) ATPR 40-012 (*Re QCMA)*:

> A market is the area of close competition between firms or, putting it a little differently, the field of rivalry between them…Within the bounds of a market there is substitution – substitution between one product and another, and between one source of supply and another, in response to changing prices…
>
> It is the possibilities of such substitution which set the limits upon a firm's ability to 'give less and charge more'. Accordingly, in determining the outer boundaries of the market we ask a quite simple but fundamental question: if the firm were to 'give less and charge more' would there be, to put the matter colloquially, much of a reaction?[12]

This formulation was referred to with approval by the High Court in *Queensland Wire Industries Pty Ltd v Broken Hill Pty Co Ltd* (1989).[13]

In its 1998 Determination the Commission defined the relevant market as follows:

- product markets: gas and gas transmission.

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[11] *Queensland Wire Industries Pty Ltd v The Broken Hill Proprietary Company Limited & Anor* (1989) ATPR 40-925 at 50,008; *Australian Meat Holdings Pty Ltd v Trade Practices Commission* (1989) ATPR 40-932 at 50,104.

[12] ATPR 40-012 at 18,196 to 18,197.

[13] 167 CLR 177.

- geographic markets: southeast 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 taken.

- functional market: in relation to the gas market, the wholesaling of gas by producers to retailers and large industrial customers.[14]

5.1.1 Product market

The product market is made up of those goods or services that could be substituted in demand or supply, by buyers or sellers, in response to a small but significant and non-transitory increase in price (SSNIP).

The starting point for determining the product market is the activities to which the MSOR relate. These activities include:

- the operation of Victoria's spot market for wholesale gas; and

- the operation of the PTS, through which gas is transported.

Natural gas markets

For natural gas, the relevant question is whether a gas market exists, or whether gas is part of a wider energy market that includes electricity.

This may be determined by applying the *Re QCMA* test. The examination of actual and potential substitutes should extend to substitutes in supply as well as in demand.

Applying this approach, the Commission should consider both the ability of end users of gas to use fuels other than natural gas, and the ability of suppliers of other products similar to gas, to enter the gas market.

The latter possibility seems remote. The infrastructure required to extract and process natural gas (two activities that are generally performed by the same entity) is highly specialised, and requires substantial capital investment. The infrastructure used, say, to generate electricity could not be switched to producing gas instead.

The question of whether end users of gas can substitute gas for electricity warrants consideration.

In its 1998 Determination the Commission concluded that the majority of end use customers do not substitute gas for other energy sources.[15] VENCorp submits that the market definition adopted in the 1998 Determination continues to be the correct one.[16] AGL supports this view.[17]

Energex argues that the gas and electricity markets are jointly exhaustive. Energex states:

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[14] ACCC 1998 Determination p. 19.

[15] ACCC 1998 Determination p. 15.

[16] VENCorp submission 20 May 2002 p. 14.

[17] AGL submission 28 June 2002 pp. 2-3.

> … we believe that it is more appropriate to consider that the two markets collectively form a whole; an energy market with discrete and separate value as individual energy sector commodities but with increasing value as a cross basis product.[18]

As evidence for this position, Energex cites the increasing uptake of gas-fired electricity generation. This appears to suggest that there is complementarity between the two products.

Energex did, however, comment about the substitutability of electricity and gas. Energex considers that while some substitution does occur at the retail level, it is confined to 'mass market' sectors like water and space heating, and that few industrial or large commercial customers are willing to switch.[19]

The correct means of evaluating this view is the SSNIP test. The extent to which gas users are likely to switch to electricity in the event of a price rise depends on both the magnitude of the price rise and the capital costs of switching. Householders may take the view that the costs of switching outweigh the impact of short-term price rises. The issue of substitutability is more likely to arise when arrangements for space heating, water heating and cooking are replaced.

The Tribunal has considered this issue on several occasions. The Commission has already quoted the relevant passage from *AGL Cooper Basin,* in which the Tribunal held that a gas market, extending at times to include electricity, exists. In *Duke Eastern Gas Pipeline*, the Tribunal considered, in a passage already quoted, that little competition between energy sources exists.[20]

The Commission accepts that this continues to be the correct view.

Is gas transmission a separate product market?

The Tribunal considered gas transmission to be a separate product market in *Re AGL Cooper Basin*:

> We find that there are three product markets of relevance for this application. The first is natural gas, extending at the margin to encompass, at times, alternative and complementary energy sources, principally electricity. When we refer to the "natural gas market", it should be understood in this extended sense. Then there are two further product markets, the services of transmission and reticulation.[21]

In its 1998 Determination the Commission concurred with this formulation. The Commission wrote:

> …the Commission considers, for the purposes of this application, that the Tribunal's approach of treating gas transmission and gas as separate but complementary product markets is more likely to reflect the emerging arenas of competition in the gas industry.[22]

In *Duke Eastern Gas Pipeline Pty Ltd* [2001], however, the Tribunal moved away from this view:

> It was agreed that the product of concern is mainly gas as there is little competition between energy sources at this time. It was agreed that gas transmission services are provided in the gas transmission

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18 Energex submission 17 June 2002 p. 7.

19 Energex submission 17 June 2002 p. 8.

20 *Duke Eastern Gas Pipeline* at 21.

21 *Re: AGL Cooper Basin Natural Gas Supply Arrangements* ATPR 41-593 at 44,210-44,211.

22 ACCC Determination 1998 p. 18.

market which is functionally separate from other parts of the gas market. Other functional areas are exploration, production/processing, sales and distribution/reticulation.[23]

Accordingly, the Tribunal appeared to take the view that gas transmission services constitute a functional level within a broader gas product market.

The Commission notes that some difficulties may emerge with this formulation. The product market is generally defined as the smallest area over which a hypothetical monopolist could potentially exercise market power. It is arguable that a hypothetical monopoly pipeline owner might be in a position to exercise market power by imposing a SSNIP on shippers. This concern underpins the rationale for the third party access regime provided by the Code.

Accordingly, a hypothetical monopolist might need to expand their operations no further than transmission in order to be in a position to impose a SSNIP.

However, as the issue is not contentious in the present matter, the Commission concurs with the product market definition adopted by the Tribunal in *Duke Eastern Gas Pipeline.*

Conclusion

On the basis of submission received and discussions with interested parties, the Commission agrees with the product market definitions in *Duke Eastern Gas Pipeline* and *AGL Cooper Basin*. Accordingly, the Commission considers that the relevant product market is natural gas.

5.1.2 Geographic market

The geographic market is the geographic area in which sellers distribute the product and in which purchasers can practicably look for supply of substitutable goods or services.

In its 1998 Determination the Commission considered there to be a southeast Australian gas market, but noted constraints on the flow of gas between Victoria and New South Wales.[24]

VENCorp and AGL submit that this continues to be the case. Energex, however, submits that the relevant geographic market is the area supplied by the PTS as described in the service envelope agreement.[25] Energex argues that this is the case because of the interrelationship between GasNet's access application, VENCorp's access arrangement application and VENCorp's application for re-authorisation.

In relation to Energex' argument, the Commission considers that it is conceivable that the geographic market extends beyond Victoria, notwithstanding the interrelation between the access arrangements of GasNet and VENCorp, and VENCorp's application for authorisation. Although the Victorian system has a number of features that do not extend beyond Victoria, such as market carriage, it is possible nonetheless that Victoria is part of a wider geographic market. This may be inferred from section 4E, which places particular importance on the nature of potential substitutes in defining markets. Similarly, cases such as *Australian Meat Holdings* (1988) have emphasised the importance of alternative sources of supply in delineating geographic markets.

In *AGL Cooper Basin*, the Tribunal held:

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[23] ACompT 2 at 21.

[24] ACCC 1998 Determination p. 19.

[25] Energex submission 17 June 2002 p. 8.

> The geographic dimension of the natural gas market has been expanding from NSW in 1986 to southeast Australia (NSW, Victoria, South Australia and Southern Queensland) today. [26]

Likewise in *Duke Eastern Gas Pipeline*, the Tribunal found that the relevant geographic market is southeast Australia.[27]

The question of geographic market definition turns on two issues:

- delineation of the relevant area over which sellers of gas supply or could supply; and
- delineation of the relevant area to which buyers of gas can effectively turn.

In relation to the first issue, the answer is clear. Gas from the Gippsland basin currently supplies both Victoria and New South Wales (via the Eastern Gas Pipeline), and will shortly supply Tasmania as well. Furthermore, gas from the Otway basin (some of which may enter the Victorian system) is likely in future to reach South Australia.

Addressing the second issue, it appears that Bass Strait is the overwhelmingly predominant source of gas for Victorian customers. To illustrate this, flows across the Interconnect[28] from New South Wales into Victoria are typically 50 TJ/day. With further compression at Young these may reach 92 TJ/day.[29] By comparison, demand for gas in Victoria regularly exceeds 1000 TJ on winter days.[30] The pipeline from Longford to Melbourne has a capacity of 990 TJ/day.[31] Accordingly, flows into Victoria from New South Wales would typically constitute a small proportion of total gas consumption in Victoria.

Accordingly, while Victorian gas may have some capacity to constrain gas producers in other states, the reverse does not appear to be true: gas from other states does not constrain BHP/Esso. Retailers in Victoria appear to source most of their gas from Esso/BHP. Because of this, it is likely that the geographical market at the retail level is likely to be narrower than the geographical market at the wholesale and transmission levels respectively.

The logical conclusion to draw from this analysis is that gas wholesale in Victoria is part of an emerging southeast Australian geographic market. This is consistent with the finding of the Tribunal in the *Duke Eastern Gas Pipeline*. This market is still patchy in some areas but better established in others. For example, NSW now consumes significant amounts of gas from both the Cooper Basin and Bass Strait, and South Australia appears likely to do so in the near future. While Victoria's integration into this market appears to be more uneven, a southeast Australian market appears nonetheless to be the most accurate.

It should also be considered how this situation is likely to change over time. In relation to both supply and demand side market characteristics, it appears the foregoing analysis considers most or all of the prospects for future development.

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26 *AGL Cooper Basin* at 44,211-44,212.

27 *Duke Eastern Gas Pipeline* at 21.

28 The Interconnect links the PTS with the Moomba to Sydney Pipeline at Culcairn.

29 VENCorp submission 20 May 2002 p. 36.

30 Terry Grimwade, Market Carriage in Victoria: Debunking the Myths *Australian Gas Journal* September 2001 p. 20.

31 Terry Grimwade, Market Carriage in Victoria: Debunking the Myths *Australian Gas Journal* September 2001 p. 20.

5.1.3 Functional market

The functional dimension of a market is that part or those parts of the supply chain relevant to consideration of the competition issue at hand. In order to identify the relevant functional dimension of the market, it is relevant to consider both the economics of vertical integration and whether substitution possibilities at a functional level (in either the product or the locations at which the product is supplied) constrain the players at another functional level from imposing a SSNIP or from otherwise exercising market power.[32]

In its 1998 Determination, the Commission considered that the relevant functional market was the wholesaling of gas by producers to retailers and large industrial customers. The Determination took the view that gas and gas transmission are functionally separate but complementary product markets.[33]

As discussed above, the Tribunal considered in *Duke Eastern Gas Pipeline* that gas transmission is a functionally separate component of a gas product market.

The Commission concurs with this view. The fact that the PTS is covered under the Code gives some indication that it is not constrained by other functional levels.

The other important issue in this regard is whether the wholesale market (i.e. the sale of gas by producers to retailers and large customers) should be regarded as functionally separate from other markets such as retail and distribution. In its 1998 Determination the Commission considered that the relevant market was the wholesaling of gas to retailers and large customers.[34] The Commission received no submissions to the current application questioning this finding.

The Tribunal found in *Duke Eastern Gas Pipeline* that separate functional markets exist in exploration, production/processing, sales and distribution/reticulation.[35]

Furthermore, the absence of vertical integration between wholesale and retail levels indicates prima facie that the two markets are functionally separate. Accordingly, the Commission considers that the position adopted by the Determination in 1998 remains correct. The Commission considers that the relevant functional markets are gas wholesale and gas transmission.

5.1.4 Conclusion

The Commission's findings in relation to market definition are:

Product market: gas;

Geographic market: emerging south east Australian market, with some constraints on gas entering Victoria from basins other than Bass Strait; and

Functional markets: gas wholesale and gas transmission.

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[32] Rhonda Smith and Neville Norman (1996) Functional Market Definition, *Competition and Consumer Law Journal*; Rhonda Smith and Jill Walker (1998) Part IIIA, Efficiency and Functional Markets, *Competition and Consumer Law Journal* Vol. 5 No. 3 April 1998 pp. 183-208.

[33] ACCC 1998 Determination p. 18.

[34] ACCC 1998 Determination p. 19.

[35] *Duke Eastern Gas Pipeline* at 21.

5.2 Counterfactual

In the course of applying section 90 of the TPA the Commission is required to apply a 'future with and without test'. As the Tribunal stated in *Re Media Council of Australia & Ors* [36] (in the context of a review of a Determination by the Commission to revoke an earlier Determination):

> …in the course of determining relevant public benefit and detriment the Tribunal must compare the position which would or would be likely to exist in the future, on the one hand if the authorisation were to continue, and on the other hand if it were absent.

This 'future with and without test' is to be applied in the context of the relevant market(s) identified by the Commission. The Commission must determine and assess what the state of the relevant markets would be (at the relevant time in the future) both with and without the proposed conduct.

The Commission considers that the purpose of the with and without test is limited to assisting it to determine what benefits and detriments 'would result from the proposed conduct' should it be authorised and carried out (*Re John Dee* (1989)).[37] It is a tool used to assist the Commission to establish whether the proposed conduct results in the alleged benefits and detriments.

It follows that it is not necessary to establish that the proposed conduct is the only possible way of achieving the alleged benefits (see *In re Tooth: In re Tooheys* (1979)).[38] It is sufficient if it is established that the relevant conduct leads – as a matter of cause and effect – to the occurrence of those benefits, even if other modalities of conduct could also hypothetically lead to the achievement of the same results. The question is whether, in the absence of the proposed conduct, the claimed benefits and detriments would occur, and if so to what extent.

In its 1998 Determination the Commission concluded that contract carriage was the relevant counterfactual.[39]

Applicant's submission

VENCorp submits that the relevant counterfactual is another form of market carriage.[40] VENCorp makes the following arguments to support its position:

- the Victorian gas market has developed on a market carriage model, as reflected by the current contractual, legal and regulatory arrangements;
- market carriage is enshrined by Victorian legislation;
- market carriage enjoys widespread support among market participants; and
- the Victorian government has indicated its support for the current market carriage arrangements.[41]

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36 (1996) ATPR 41-497 at 42,241.

37 ATPR 40-938 at 50,206.

38 ATPR 40-113 at 18-187.

39 ACCC 1998 Determination p. 20.

40 VENCorp submission 20 May 2002 pp. 14-19.

41 VENCorp submission 20 May 2002 pp. 16-19.

VENCorp submits that if the Commission did not grant authorisation, the MSOR would subsequently be amended to address the Commission's concerns. Alternatively, other arrangements would be made to support the ongoing operation of market carriage.

Interested parties' submissions

Energex, AGL and TXU agree with VENCorp's view of the counterfactual.

Energex submits:

- a 'complex and intricate maze of interrelated legislative and regulatory instruments' would make it difficult to dismantle market carriage;
- contract carriage might not be able to facilitate full retail contestability; and
- a fundamental change in Victoria's gas transportation system is, however, theoretically possible.[42]

Energex considers the only credible counterfactual to be 'another form of market carriage consistent with the basic tenets in the current authorisation'.[43] Energex lists several possible alternatives, indicating that the task of choosing between these alternatives should be left to VENCorp.

Likewise, AGL argues:

- it is unlikely that the Victorian government would legislate a return to contract carriage; and
- the correct counterfactual is a version of market carriage that would satisfy the Commission's concerns.[44]

TXU submits:

- legislative and technical considerations 'lock in' the MSOR; and
- issues relating to property rights would also constitute an obstacle to implementing any alternative system.[45]

TXU contends that a failure to authorise the MSOR would lead principally to uncertainty.

The Department of Natural Resources and Environment (DNRE) submits:

- the MSOR are enacted by statute;
- market carriage was developed as part of structural reforms designed to create a competitive natural gas market;
- contract carriage is not a viable option in Victoria, given the physical characteristics of the system; and

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42 Energex submission 17 June 2002 pp. 5-6.

43 Energex submission 17 June 2002 p. 6.

44 AGL submission 28 June 2002 p. 2.

45 TXU submission 17 July 2002 pp. 3-4.

- the Victorian government remains committed to market carriage.[46]

Esso argues that if the MSOR were not authorised, market players at all functional levels would enter bilateral contracts covering the supply, demand and balancing of gas. This would constitute a contract carriage system.[47]

Applicant's response

In its response to submissions by interested parties, VENCorp reiterates that:

- market carriage is enshrined in Victoria by legislative, operational and technical requirements; and

- market carriage (including VENCorp) enjoys the support of the Victorian government.[48]

Commission's considerations

The Commission considers it should determine what the relevant markets are likely to look like in the medium to long term in the absence of the relevant conduct. The Commission must have regard to commercial likelihoods and the competitive functioning of the industry (*Re QCMA*[49]). In other words, it must take a pragmatic (realistic) and commercial approach to assessing what the state of the relevant market would be in the absence of the MSOR.

As VENCorp and several retailers argue, the process of determining the alternative scenario is complicated by the following factors.

- Since the Commission released its last Determination, the MSOR has been enacted and brought into force, and market carriage has been operating since March 1999.

- The MSOR may be viewed as part of a broader set of ongoing reform measures in the Victorian gas industry. For example, the MSOR is linked to the access arrangements for the transmission pipelines in Victoria, introduced pursuant to the Code. If the MSOR were not authorised, it needs to be considered how this would affect other components of Victoria's integrated gas market reforms, including the imminent introduction of full retail contestability.

- Market carriage and an independent systems operator is enshrined by Victorian legislation.

- There is doubt as to whether a contract carriage system would work in Victoria, given the physical characteristics of the PTS.

These factors make it difficult for the Commission to form a precise view of how the markets defined would evolve should the Commission not authorise the MSOR. The actual situation that would come about depends on the likely reaction of all players in the market to such a development. This includes the likely response of VENCorp, retailers, GasNet, Esso and other potential suppliers of gas, and the Victorian government.

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46 DNRE submission 14 August 2002 pp. 1-2.

47 Esso submission 19 July 2002 p. 2.

48 VENCorp submission 19 August 2002 pp. 2-5.

49 ATPR 40-012 at 17,244.

The likely future scenario also depends on the nature of the Commission's view of the MSOR. It depends on the extent of the Commission's concerns as to the anticompetitive effects of the MSOR, the amendments it would require, and the attitude it subsequently took to revisions suggested by VENCorp.

Therefore it is logical to postulate a range of potential future situations. The relevant counterfactual could either be:

- the markets for wholesale supply and transmission of gas incorporating some variation on the market carriage model currently embodied in the MSOR; or
- the markets for wholesale supply and transmission of gas incorporating a variation on contract carriage, taking into account the effects of the introduction of the reforms and the particularities of the Victorian gas industry; or
- a combination of these.

The issue, raised by several submissions, of the harm or benefit that would arise if authorisation were not granted, is best addressed in the section of this *Final Determination* dealing with net public benefit. In applying the 'with or without' test, the Commission should consider the costs of switching to an alternative system.

6. Assessment of potential public benefit and detriment

6.1 Public Benefits

VENCorp argues that numerous public benefits flow from the continued operation of the MSOR. These include the facilitation of wholesale competition, efficient development of the gas market, and the promotion of price discovery. The Commission has assessed each of the public benefits claimed by VENCorp, as well as the views of interested parties on these claimed benefits.

The benefits claimed by VENCorp may be arranged into the following categories:

- direct benefits from the operation of the spot market;
- benefits resulting from increased wholesale competition; and
- other potential benefits.

6.1.1 Applicant's submission

VENCorp argues that the continued operation of the MSOR would result in the following public benefits in relation to an increase in wholesale competition:

- efficient operation of the transmission network and market;
- efficient medium and long term development of the gas market;
- promotion of price discovery;
- facilitation of interstate trade; and
- openness and transparency of MSOR.[50]

VENCorp submits that the following additional benefits are likely to result from the continued operation of the MSOR:

- efficient use of resources;
- system security and reliability;
- protection against potential market abuse;
- maintaining consistency with current arrangements;
- facilitating retail competition; and
- harmonisation of energy markets.[51]

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[50] VENCorp submission 20 May 2002 pp. 29-41.

Efficient operation of the transmission network and market

VENCorp argues that market carriage and the spot market provide for a market based approach to trading imbalances and managing constraints. VENCorp submits:

> 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.[52]

VENCorp argues that the price of imbalances is determined by the bids submitted by market participants each day. VENCorp stresses the role of price signals as a means of overcoming system constraints.[53] VENCorp also claims that this system has operated well since market commencement, as evidenced by:

- the flexible reaction by the market to episodes of stress; and
- minimal intervention by VENCorp.

Efficient medium and long term development of the gas market

To support its claim that the MSOR facilitate efficient development of the gas market, VENCorp discusses numerous gas production and transmission projects that have occurred since 1998, or are expected to eventuate in the short to medium term. These developments include:

- the completion of the Interconnect;
- the completion of WUGS;
- the connection of the Yolla gas fields to the PTS; and
- the development of the Patricia Balleen, Minerva/Thylacine, Yolla and Kipper gas fields.[54]

VENCorp submits that these developments have been, and will continue to be, assisted by competitive industry reforms, in which the MSOR play a role. VENCorp also argues that these developments have enhanced the competitiveness of gas trading arrangements in Victoria, and will continue to do so in future.[55]

Promotion of price discovery

VENCorp submits that the MSOR promote transparency in the wholesale price of gas. This leads to an efficient allocation of resources.[56]

Facilitation of interstate trade

VENCorp argued that the volume of gas flows across the Interconnect – usually about 50 TJ/day – demonstrates that the MSOR facilitate interstate trade.[57] VENCorp also quotes the

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51 VENCorp submission 20 May 2002 pp. 41-52.

52 VENCorp submission 20 May 2002 p. 32.

53 VENCorp submission 20 May 2002 p. 32.

54 VENCorp submission 20 May 2002 pp. 33-34.

55 VENCorp submission 20 May 2002 p. 33.

56 VENCorp submission 20 May 2002 p. 35.

57 VENCorp submission 20 May 2002 pp. 37-8.

AGA's submission to the CoAG Energy Market Review, which stated that a lack of upstream competition, rather than different market approaches, constrains natural gas markets in Australia.[58]

VENCorp also argues that any difference between market carriage in Victoria and contract carriage in neighbouring jurisdictions should be viewed in the light of considerable differences of configuration among the various contract carriage systems.

Finally, VENCorp contends that shippers do not have to book capacity to transport gas on the PTS, facilitating interstate trade.[59]

Openness and transparency of the MSOR

VENCorp claims that it provides a wide range of information on market and system operation, including:

- schedules and forecasts of price;
- information on market outcomes;
- participant bids;
- the Gas Market Report; and
- the Victorian Energy Update.[60]

VENCorp argues that this information provides the basis for better decision making by market participants and potential market participants in relation to a wide range of matters, including:

- planning for capital investments;
- system maintenance;
- gas storage; and
- pipeline operation.[61]

VENCorp also submits that its rule change process is fair, equitable and transparent.[62]

System security and reliability

VENCorp acknowledges that the primary responsibility of any systems operator is to ensure the security of the transmission system and gas delivery. This can be achieved either through incentives via the operation of the market, or through intervention by the systems operator. VENCorp argues that the current arrangements in Victoria minimise the need for direct intervention by the systems operator, and maximise the extent to which market participants can voluntarily ensure safety through their decisions in the market. One example of this is the

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58 Australian Gas Association submission to the COAG Energy Market Review, April 2002.

59 VENCorp submission 20 May 2002 p. 38.

60 VENCorp submission 20 May 2002 pp. 39-40.

61 VENCorp submission 20 May 2002 p. 40.

62 VENCorp submission 20 May 2002 p. 40.

potential for demand side response to system constraints. VENCorp submits that this system maximises allocative efficiency.[63]

VENCorp also submits that the MSOR comprehensively set out VENCorp's responsibilities in relation to intervention in the event of threats to system. VENCorp submits that this leads to:

- better management of security risks and threats;
- more efficient use of system capacity;
- reduced threats to the system;
- reduced need for VENCorp intervention; and
- more reliable supply of gas to customers.[64]

VENCorp also argues that because of its provision of market information to participants, they have real time knowledge of potential system constraints.[65]

Efficient use of resources

VENCorp claims that the MSOR encourage the efficient use of two classes of resources:

- gas production and consumption reserves; and
- the PTS.

In relation to the first, VENCorp argues that under the spot market arrangements, market participants make decisions to buy and sell gas based on pricing signals. Market participants have the option to buy or sell gas on the spot market rather than simply trade it through long term contracts. VENCorp argues that market participants have taken steps to obtain more flexible gas supplies to respond to these pricing signals.[66]

VENCorp also claims that the MSOR lead to efficient utilisation of the PTS, resulting in allocative efficiency.[67]

Protection against potential for market abuse

VENCorp submits that public benefits result where there are effective arrangements in place to enable monitoring of any potential market abuse, in part because it results in increased confidence to market participants and potential entrants and reduces barriers to entry.[68]

Under clause 1.2.1 of the MSOR VENCorp must monitor and report on significant price variations. Under clause 7.1 of the MSOR VENCorp must monitor the operation of the MSOR and the compliance of market participants with the MSOR, investigate potential breaches and report on those to the Commission.

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63 VENCorp submission 20 May 2002 p. 42.

64 VENCorp submission 20 May 2002 pp. 42-3.

65 VENCorp submission 20 May 2002 pp. 42-3.

66 VENCorp submission 20 May 2002 pp. 42-3.

67 VENCorp submission 20 May 2002 p. 42.

68 VENCorp submission 20 May 2002 p. 43.

VENCorp submits that since the MSOR commenced operation, it has found no evidence of anti-competitive behaviour.

Maintaining consistency with current arrangements

The applicant submits that if the Commission authorised the MSOR, this would maintain consistency and stability in the Victorian gas industry, which would represent a benefit to the public.

VENCorp notes that the MSOR are consistent with the following:[69]

- existing legislation and regulations, particularly the Gas Industry Act, the *Gas Pipelines Access Act 1998* (Vic) and the *Gas Safety Act 1997* (Vic), which impose requirements on VENCorp and various market participants to comply with the MSOR;
- the access arrangements submitted by VENCorp and GasNet to the Commission on 28 March 2002, in relation to the PTS, which were submitted on the basis that market carriage and the MSOR would continue; and
- the Retail Gas Market Rules relating to retail contestability, which were authorised and approved by the Essential Services Commission (the ESC) under the Gas Industry Act.

Furthermore, VENCorp argues that an environment of stability and certainty would result in the following benefits:[70]

- it would assist commercial decision making, such as decisions to undertake new investment or enter the Victorian gas industry, which are vulnerable to uncertainty;
- it would allow VENCorp and industry participants to retain their investment in understanding of the current arrangements; and
- it would avoid disrupting a live market, which might occur if the Commission were to pursue actions for breaches of the TPA, or if revision and renegotiation of contracts became necessary.

Facilitation of retail competition

VENCorp claims that the MSOR have facilitated retail competition, and that this will be enhanced when full retail contestability is introduced.

In support of its submission, VENCorp notes that:[71]

- market carriage enables all participants, regardless of size, to buy and sell gas through the spot market at the same market clearing price;
- there are 13 market participants under the MSOR, of which eight are licensed retailers, direct participants and traders; and

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69 VENCorp submission 20 May 2002 p. 44.

70 VENCorp submission 20 May 2002 pp. 44-46.

71 VENCorp submission 20 May 2002 pp. 47-48.

- churn rates (the rates at which customers switch from one retailer to another) for contestable customers exceed 20 per cent, while churn rates exceed 25 per cent for customers who use in excess of 10 TJ daily.

VENCorp submits that market carriage systems are more conducive to retail competition than contract carriage systems. VENCorp argues that on the Western Transmission system (the WTS), a Victorian pipeline system operating on contract carriage, several impediments to customer churn exist, such as the current capacity contracts between the pipeline owner and incumbent retailers.[72]

VENCorp argues that under a contract carriage system, where a new retailer wins a customer, that retailer might have difficulty obtaining transmission capacity if the pipeline capacity is fully contracted. If the incumbent retailer has contracted transmission capacity and does not sell it to the new retailer, the new retailer could be forced to fund an expansion to the system or accept interruptible capacity that could affect their contract with their customer. This situation does not arise under market carriage, because there is no requirement to contract transmission capacity. Under the current arrangements, existing customers hold Authorised Maximum Daily Quantity (AMDQ), which they retain if they change retailers.[73]

Harmonisation of energy markets

VENCorp submits that the MSOR, and market carriage in Victoria generally, could potentially assist in the development of wider gas markets, and in the harmonisation of gas and electricity markets.

VENCorp cites several factors already discussed as facilitating this process:

- the ability of the PTS to interface with other systems;
- the positive impact of trade between NSW and Victoria; and
- allocative efficiency through the promotion of price discovery.[74]

VENCorp discusses two further issues that will affect the harmonisation of energy markets:

- the potential for a Victorian trading hub, linking Victorian, NSW, Tasmanian and South Australian markets; and
- the importance of meeting the needs of gas-fired generation.[75]

6.1.2 Interested parties' submissions

Several interested parties comment about the overall effectiveness of the MSOR.

AGL submits:

> We believe that the current arrangements based on the 'market carriage' model are effective and, importantly, that the MSOR contain adequate mechanisms for review and modification.[76]

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72 VENCorp submission 20 May 2002 pp. 47-48.

73 VENCorp submission 20 May 2002 p. 48.

74 VENCorp submission 20 May 2002 p. 50.

75 VENCorp submission 20 May 2002 pp. 50-51.

Energex argues that the MSOR probably provide an overall public benefit.[77] Likewise, Visy considers that the market structure is working well.[78]

TXU submits that the gas market as governed by the MSOR is working fundamentally well at present, and provides the following benefits:

- transparency;
- low barriers to entry; and
- it contributes to a competitive wholesale and retail environment.[79]

DNRE considers that the current arrangements in Victoria have proven to be 'workable and effective'.[80] DNRE expresses the view that the following benefits have resulted from the introduction of market carriage in Victoria:

- VENCorp's role has provided transparency and accountability to the PTS;
- the MSOR have promoted an open access, competitive gas market; and
- gas transport on the PTS has to date been safe and reliable.[81]

Interested parties also made a number of specific comments.

Energex comments that the MSOR have promoted some degree of wholesale competition, but considers that a lack of upstream competition has constrained the realisation of this benefit.[82]

Energex submits:

> Based on ENERGEX's market experience, we are persuaded that the MSOR has been effective in promoting a degree of wholesale competition. However, given the lack of real upstream competition, the level of saving that can be expected is minimal.[83]

Energex also comments:

> ENERGEX is comfortable that the VENCorp proposal adequately caters for Victoria's unique gas security requirements.[84]

Energex notes that it is not aware of any instances of market abuse related to the MSOR and contends that the MSOR ensure open market discovery processes and enhances transparency of the prevailing market dynamic, which are significant for the detection of instances of market abuse.[85]

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76 AGL submission 28 June 2002 p. 1.

77 Energex submission 17 June 2002 p. 10.

78 Visy submission 23 July 2002 p. 1.

79 TXU submission 17 July 2002 p. 1.

80 DNRE submission 14 August 2002 p. 3.

81 DNRE submission 14 August 2002 pp. 2-3.

82 Energex submission 17 June 2002 p. 10.

83 Energex submission 17 June 2002 p. 10.

84 Energex submission 17 June 2002 p. 11.

85 Energex submission 17 June 2002 p. 11.

Energex agrees that maintaining consistency with the current arrangements would result in a public benefit.[86] This is primarily because participants need certainty to underpin their commitment in an industry, particularly in the gas industry where retailers still enter into long term contracts with upstream producers.[87]

Energex argues that the MSOR have been effective in facilitating contestability to date and in respect of full retail contestability, while the MSOR is untested, it is consistent with the needs of a contestable mass market.[88]

Esso claims that, contrary to VENCorp's claims, the MSOR acts as a disincentive to investment. Esso argues that the following factors contribute to this effect:

- the complexity of the MSOR;
- the differences between the MSOR and other jurisdictions; and
- the inability of gas producers to obtain long term sales contracts to underpin investment.[89]

Esso also comments on some of the practical difficulties of transporting gas in and out of Victoria, particularly in relation to obtaining firm capacity rights.[90] The Commission has discussed these issues in its section relating to potential detriment arising from the MSOR.

Esso indicates that because of these factors, Yolla and Minerva gas would flow into South Australia, and Patricia Balleen gas into NSW.[91]

Esso submits:

> We believe that the MSOR is detrimental to the Victorian gas industry by discouraging upstream investment, efficient transmission system investment, interstate trade and market liquidity.[92]

Esso argues that several features of the MSOR are constraining the development of a broader gas market. These are:

- the complexity of the MSOR;
- the difference between the MSOR and other systems;
- the difficulties experienced by producers in obtaining firm capacity rights;
- the potential for high uplift charges; and
- the risks faced by producers bidding into the market.[93]

AGL submits:

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86 Energex submission 17 June 2002 p. 12.
87 Energex submission 17 June 2002 p. 5.
88 Energex submission 17 June 2002 p. 11.
89 VENCorp submission 20 May 2002 pp. 3, 5.
90 Esso submission 19 July 2002 pp. 2-3.
91 Esso submission 19 July 2002 p. 3.
92 Esso submission 19 July 2002 p. 1.
93 Esso submission 19 July 2002 pp. 1-8.

> AGL does not subscribe to the view that market carriage or the MSOR of themselves promote reform in other areas, rather that they help to deliver the benefit of those reforms to consumers.
>
> Conversely, AGL does not regard the absence of active trading in the wholesale gas market as evidence of any failure on the part of market carriage or the MSOR. Rather, that is the result of difficulties for new entrants to the market in gaining access to gas supplies in Victoria and uncertainty over the form and timing of retail contestability.[94]

AGL notes that if the MSOR was not authorised instability would result, which would impede the development of competition in both the wholesale and retail markets.[95]

EAG argues:

- the demand side [of the market] needs to be able to understand its risk exposure;
- ancillary and uplift payments are imprecisely defined by the MSOR; and
- the events of 22 July 2002 demonstrate a lack of transparency.[96]

EAG also notes the difficulties experienced by retailers trading across states, because of the significant differences between market carriage in Victoria and other systems. EAG notes the potential for different system balance arrangements to emerge in South Australia, Queensland and Western Australia, rendering the development of a national market more difficult.[97]

EAG encourages the Commission to adopt a strategy to facilitate the convergence of system balancing arrangements across states.[98]

DNRE submits:

> VENCorp's role has also provided transparency and accountability in the operation of the PTS and the associated wholesale gas market.[99]

DNRE also considers:

> Market Carriage provides for the PTS to be operated in ways that are market oriented. Gas is scheduled and the system balanced using price signals rather than regulation.[100]

The DNRE submits that re-authorisation of the MSOR will provide for ongoing confidence and further development of the Victorian gas industry.[101]

The DNRE submits that the MSOR best meet Victoria's long term policy aims, including full retail competition.[102]

EUAA argues that it is disadvantageous to have different market models across states, commenting:

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94 AGL submission 28 June 2002 p. 3.
95 AGL submission 28 June 2002 p. 4
96 EAG submission 19 August 2002 p. 6.
97 EAG submission 19 August 2002 pp. 5-6.
98 EAG submission 19 August 2002 p. 6.
99 DNRE submission 14 August 2002 p. 2.
100 DNRE submission 14 August 2002 p. 1.
101 DNRE submission, 14 August 2002, p 3.
102 DNRE submission, 14 August 2002, p 2.

> Differing system designs and operations in various states can also inhibit the potential for the export of gas interstate and the likelihood and viability of multi-state players in the national gas market.[103]

EUAA also argues that the difference in gas market designs across states is inhibiting the development of a national gas market.[104]

TXU agrees that the MSOR provide transparent price discovery.[105]

TXU submits that the MSOR facilitates retail competition because the spot market and market carriage model do not lock retailers into contracted positions.[106]

TXU made an extensive supplementary submission in relation to the events of 22 July 2002, and how they demonstrate a need for the introduction of locational hourly pricing.

In both its submissions, TXU discusses the requirements of gas-fired generators, and how these could be met by the introduction of locational hourly pricing. In its submission of 17 July 2002, TXU argues that because generators respond to real time signals in the NEM, they need more accurate pricing signals from the gas market.[107]

In its submission of 5 September 2002, TXU outlines how the events of 22 July 2002 underscore the need for locational hourly pricing. TXU submits that gas-fired generators were curtailed. TXU notes that gas-fired generators are designed to take advantage of peak conditions, and that they missed out on bidding into the NEM at high prices, causing them significant financial loss.

According to TXU, locational and hourly price signals would enable a demand side response to occur in such situations. It would also allow different generators to curtail voluntarily, depending on whether or not they had back up fuel.[108]

6.1.3 Applicant's response

In its submission of 19 August 2002, VENCorp questions Esso's assertion that gas from Minerva, Yolla and Patricia Balleen is committed to users outside Victoria.[109] VENCorp states:

> The level of exploration for gas, development activities and prospective commercial activity in Victoria is at historically high levels.[110]

VENCorp also clarifies its assertion as to the relationship between the MSOR, natural gas reforms in Victoria more broadly, and investment. VENCorp argues that, rather than compelling upstream reform, the wholesale market facilitates the delivery of reform benefits to consumers.[111]

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[103] EUAA submission 6 August 2002 p. 12.

[104] EUAA submission 6 August 2002 pp. 11, 12.

[105] TXU submission 17 July 2002 p. 5.

[106] TXU submission 17 July 2002 p 5.

[107] TXU submission 17 July 2002 pp. 6-7.

[108] TXU submission 5 September 2002 pp. 3-5.

[109] VENCorp submission 19 August 2002 p. 17.

[110] VENCorp submission 19 August 2002 p. 17.

[111] VENCorp submission 19 August 2002 p. 17.

VENCorp also discusses Esso's concerns relating to the inability of producers to enter long-term gas supply contracts. VENCorp suggests that the MSOR do not preclude the formation of long term contracts, and that most gas in Victoria is traded under these instruments.[112]

6.1.4 Issues arising since the Draft Determination

At the predetermination conference, EAG and EUAA commented that VENCorp's communications with players in the market, including energy users, have been unsatisfactory to date.

EAG indicated that its members were unaware of the events of 22 July 2002 until several days afterwards. EUAA said some of its members did not know even a week afterwards.

EAG also submitted at the predetermination conference that VENCorp's website does not provide adequate information as to what is occurring in the market.

EUAA indicated that it had held discussions with VENCorp, and that progress was being made on this matter.

At the predetermination conference, VENCorp acknowledged that some issues persist with communications, but that VENCorp is working with users' groups to address these. VENCorp also argued that its website provides more information than acknowledged by EUAA and EAG.

In its submission of 5 December 2002, TXU supports the Commission's view that issues such as single zone daily pricing are currently preventing the harmonisation of energy markets.[113]

6.1.5 Commission's considerations

Direct benefits resulting from the operation of the spot market

Efficient gas balancing

Any transmission system requires balancing rules. Under a contract carriage system, shippers are required to conform to balancing requirements, pay penalties for being out of balance and if necessary follow operational flow orders. By contrast, under market carriage, imbalances are traded on the spot market. It is worth noting, however, that under market carriage, users may be required to reduce or curtail usage in emergency situations.

In its 1998 Determination, the Commission considered that balancing under market carriage is more economically efficient than under contract carriage. The Commission noted several benefits of market carriage:

- where possible, the system works on the basis of market signals;
- market participants are given clearer pricing signals, which allow them to make optimal production, consumption and investment decisions;
- gas can be bought and sold without long term contracts; and

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[112] VENCorp submission 19 August 2002 p. 17.

[113] TXU submission 5 December 2002 p. 5.

- in the first instance, system security issues can be addressed by market solutions and, if necessary, by VENCorp intervention.[114]

The Commission continues to believe that performing the gas balancing function using a spot market engenders public benefit. The spot market enables market participants to trade gas in a transparent manner. It also allows prices to be determined in a way that reflects supply, demand and system constraints, and other relevant factors. The Commission accepts that the spot market provides price signals that allow, to a significant extent, a market based solution to system constraints. This outcome is obtained using a market model that limits the extent of intervention by the systems operator in price setting. The Commission considers that these factors exist to a greater degree under market carriage that would be the case under contract carriage.

Accordingly, the Commission accepts efficient gas balancing as a public benefit flowing from the continuation of the MSOR.

If the counterfactual is another form of market carriage, the Commission is unable to state whether this alternative system would provide superior system balancing capability.

The Commission accepts VENCorp's submission that it performs its functions at a reasonable cost. However, operating market carriage at reasonable cost does not in itself represent a public benefit. There is no strong evidence that market carriage is performed more cheaply than contract carriage would be. VENCorp has offered no evidence that market carriage, as currently configured, costs less than some alternative form of market carriage.

The Commission also agrees with Energex that the extent of these benefits has been constrained by the lack of upstream competition. If further gas supplies from the Otway basin enter the PTS, this, combined with the advent of full retail contestability, should amplify the benefits from spot trading. These developments should lead to an increased number of producers and market participants. When market carriage has attained greater volumes of gas traded, from more sources, the advantages of a spot market over more conventional gas trading and balancing mechanisms should become apparent.

Improved network services

In its 1998 Determination the Commission considered that the arrangements facilitated by the MSOR allow for easier entry of gas shippers, because shippers do not need to commit to a certain capacity for a fixed period, as under contract carriage.

The Commission continues to take the view that market carriage provides a public benefit by dispensing with the need for formal long-term haulage contracts.

System security and reliability

The Commission accepts the views of VENCorp and DNRE that the MSOR facilitate a market-based approach to solving security issues. That is, the MSOR provide for the possibility of demand side response to transmission constraints. The Commission notes, however, that demand side response to the constraint that arose on 22 July 2002 was negligible. The Commission agrees with TXU's view that the introduction of locational hourly pricing might encourage more demand side response. This could potentially enhance the public benefit resulting from the MSOR.

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[114] ACCC 1998 Determination pp. 23-4.

The Commission considers that the rules relating to system security measures such as curtailment would be spelled out under any systems operation model. Therefore this feature of the MSOR, and its attendant claimed benefits, does not constitute a benefit to the public resulting from the MSOR.

Efficient use of resources

This potential public benefit is linked to efficient balancing, and to the provision of clear price signals. The Commission accepts that the MSOR lead to these outcomes and accordingly promote allocative efficiency.

The Commission notes that under contract carriage, shippers may also elect to trade gas rather than simply accept their contracted quantities. However, market carriage in Victoria facilitates widespread trading of imbalances in a transparent manner. Therefore it is likely to lead to a higher degree of allocative efficiency than contract carriage. The fact that market participants are seeking more flexible sources of gas, as claimed by VENCorp, might indicate that they are responding to the accurate pricing signals provided by the MSOR.

However, the Commission is aware of no evidence that the MSOR have resulted in the PTS operating more efficiently than it would under contract carriage, or under an alternative version of market carriage. Accordingly, the Commission is unable to accept efficient operation of the PTS as a benefit likely to flow from the MSOR.

Benefits likely to result from improved wholesale competition

Efficient medium and long term development of the gas market

The Commission is not required to express a view as to where the gas that is extracted from the various Bass Strait projects is likely to be shipped. Once gas has been extracted from these fields and has been shipped to various destinations, it may be possible to draw cogent conclusions as to the effects of the MSOR and natural gas reforms in Victoria generally.

However, it appears that the MSOR are likely to facilitate the delivery of reform benefits to consumers. For example, the MSOR provide for easy access of retailers into Victorian markets. This is because with a spot market, retailers can sell gas without long-term supply contracts. Furthermore, the MSOR also provide for competitive access to the transmission network, which, over time, should facilitate the entry of new gas shippers and suppliers.

The provision of these functions has assisted in developing competition in wholesale gas markets. With these measures in place, the introduction of full retail contestability should see further gains passed on to consumers.

Furthermore, the Commission has addressed Esso's claims that it cannot enter long-term contracts in the section of this *Final Determination* relating to the perceived detriments of market carriage.

In its 1998 Determination the Commission commented:

> Nevertheless, the potential efficiency gains from downstream reforms will not be realised in the absence of a serious policy approach to the question of effective upstream gas market reform.[115]

The Commission views the MSOR as part of a broader set of reforms aimed at bringing greater competition to natural gas wholesale markets. While the operation of the spot market

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[115] ACCC 1998 Determination p. 35.

may deliver some efficiency improvements, the main long-term benefits are likely to be realised where multiple producer sell into a contestable retail market. As the market matures, these developments may eventuate, and the accompanying benefits may become more evident. As this occurs it will become clearer whether the MSOR, as part of a broader package, facilitate competition.

Promotion of price discovery

In its 1998 Determination the Commission considered:

> Further, the Commission believes the model for spot sales to be economically sound in that it potentially provides for…clearer pricing signals - giving participants information with which to make optimal production, consumption and investment decisions.[116]

The Commission agrees with VENCorp that spot trading sends price signals that engender an information rich market. By providing market participants with this information, VENCorp enables them to make efficient decisions in relation to the purchase and sale of gas. The net effect of these decisions by participants and potential participants is that scarce resources are allocated efficiently.

The Commission agrees with VENCorp that the spot market provides a greater degree of price discovery than would be the case under contract carriage. Generally under contract carriage, a user with an imbalance may trade capacity with another user, with the pipeline owner's consent.[117] Under this arrangement only the three relevant parties are aware of the price and volume traded. By contrast, under market carriage the price of gas and the volumes available are known to all market participants. This enables market participants to make efficient decisions as to buy or sell gas, and the net effect of these decisions is enhanced allocative efficiency.

If the MSOR is compared to another (unknown) system of market carriage, it is difficult to state with certainty whether the arrangements proposed engender a greater degree of price transparency than the alternative.

However, it is also clear that the MSOR could promote a greater degree of transparency through more accurate pricing mechanisms, of which locational hourly pricing would be one option. This would address issues of opacity that currently exist in relation to uplift charges, some of which are smeared across all users.

Often the drawback to greater information and a greater degree of price transparency is higher cost. The issue of whether the introduction of locational hourly pricing would generate sufficient benefit relative to its cost can best be considered through a further review by VENCorp.

Facilitation of interstate trade

In its 1998 Determination, the Commission expressed some concern about the impact of market carriage in Victoria on flows of gas out of Victoria. However, the Commission expressed less concern in relation to gas entering Victoria.[118]

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116 ACCC 1998 Determination p. 71.

117 See, for example, ACCC access arrangement for the Moomba to Adelaide Pipeline System (MAPS) clause 20.1.

118 ACCC 1998 Determination pp. 43-44.

The Commission noted that market carriage is designed to facilitate multiple injection points, and that the Interconnect can be treated as one of these injection points.

However the Commission did express concern about the potential for the MSOR to inhibit the flow of gas out of Victoria. This concern stemmed from a perceived difficulty in obtaining firm capacity rights to ship gas out of Victoria. The Commission noted that suppliers may enter firm contracts to supply gas interstate, provided they are prepared to insure against uplift.

This issue was raised by Esso in its submission to the current authorisation application. The Commission has addressed Esso's concerns in its section relating to potential public detriment.

The Commission considers that the modest quantum of uplift payments since market commencement should allay fears that interstate trade is inhibited by the MSOR. Furthermore, gas from Victoria is currently entering NSW via the Eastern Gas Pipeline. Given the volume transported on this pipeline, it is questionable whether there would be substantial additional demand in NSW for Victorian gas.

In relation to VENCorp's contentions, the Commission considers that the current flow across the Interconnect (averaging 50TJ/day) does not represent a significant volume relative to the amount of gas entering the PTS from other sources, principally Longford. Therefore this volume is not strong evidence prima facie that the MSOR encourage interstate trade.

Conversely, it does not appear that the MSOR are having a detrimental effect on interstate trade. The volume of flows at Culcairn appear to be affected by factors such as:

- the physical constraints of the Interconnect;
- the relative prices of extraction and transportation associated with gas from different basins; and
- other factors affecting gas transportation.

During its discussions with interested parties, the Commission has heard a range of explanations for the limited flow of gas across the Interconnect. The Commission is satisfied that the different system balance models in Victoria and NSW are not to blame. Furthermore, the Commission acknowledges VENCorp's efforts to facilitate interstate trade by allocating AMDQ to cover the uplift exposure of northward flows.

The Commission has addressed the points made by EAG and EUAA in its section relating to potential public detriment.

Overall, the Commission considers that, in their impact on interstate trade, the MSOR represent neither a detriment nor a benefit to the public.

Openness and transparency of the MSOR

The Commission's view of the provision of market information represents a logical extension of its views in relation to transparent pricing – namely that the provision of timely and decision-useful information promotes economic efficiency.

The Commission also considers that the information provided by VENCorp enhances wholesale competition, and consequently assists in passing the benefits of downstream reforms on to consumers.

The Commission has considered in its section on potential public detriment whether this information provided by VENCorp could be used by market participants for anticompetitive purposes. The Commission considers that this is unlikely to occur.

However, the Commission notes the concerns of EAG and EUAA in relation to communications with VENCorp. The Commission further notes VENCorp's commitment to improve communications with various stakeholders. The Commission approves this initiative of VENCorp, as it considers that effective and timely communication between VENCorp and market players is important for realising the benefits of market carriage, particularly those relating to openness and transparency.

The Commission agrees with VENCorp that the MSOR rule change process is fair and transparent. The Commission has received very few submissions from interested parties in relation to rule change applications. This indicates that the consultative process undertaken to date via the GMCC has been reasonably effective in canvassing the issues raised by market participants and other stakeholders. However, the Commission has indicated that it would prefer there to be greater end user representation on the GMCC.

Accordingly, the Commission accepts that VENCorp's provision of market information represents a benefit to the public.

Other benefits likely to result from the MSOR

Protection against potential for market abuse

Monitoring and reporting on compliance with the MSOR is necessitated by the existence of the MSOR themselves. Such requirements therefore do not result in public benefits because the requirements would not be necessary in the absence of the MSOR.

In its 1998 Determination, the Commission expressed some concern that the market information published by VENCorp, such as forecasts of likely peak daily demand, supply availability and the spot price, could facilitate anti-competitive behaviour. In particular, the Commission was concerned about the use of that information to enter into anti-competitive agreements and the ability to manipulate the spot price for commercial advantage. However, the Commission recognised that the release of information can also reduce the ability of market participants to exercise market power because spot prices can be monitored and anti-competitive behaviour identified. The Commission also recognised that information disclosure could aid the transparency and efficiency of the arrangements. Overall, the Commission concluded that disclosure of information would result in efficiency benefits and that market monitoring was warranted due to the potential for anti-competitive behaviour.[119]

Given that VENCorp has found no incidence of anti-competitive practices and the spot price is relatively flat, the Commission acknowledges that its concerns regarding gaming and other anti-competitive conduct do not appear to have eventuated.

The potential for anti-competitive behaviour of the sort that the market monitoring conducted by VENCorp is able to detect does not exist in a contract carriage system. The price of gas transmission is determined by negotiations between the pipeline owner and access seeker or based on the reference tariff determined by the relevant regulator.

Accordingly, in the absence of the MSOR and the information provided by VENCorp, it is not clear that the monitoring undertaken by VENCorp would be necessary. This is because

[119] ACCC 1998 Determination pp. 125-128.

the scope for market abuse of the kind that the monitoring conducted by VENCorp could detect would not exist. The monitoring ensures that a potential detriment does not eventuate rather than confer a benefit.

If the counterfactual was another form of market carriage, the current MSOR do not provide benefits that would not exist under another form of market carriage.

In conclusion, the Commission does not consider that public benefits flow from protection from market abuse. Nevertheless, it is appropriate that VENCorp's monitoring continue because the absence of anti-competitive conduct could be the result of the deterrent effect of monitoring.

Nevertheless, as noted above, the Commission considers that the openness and transparency of the MSOR, including transparency of pricing, does confer public benefits.

Maintaining consistency with current arrangements

The Commission agrees that retaining the current gas transmission arrangements represents a benefit to the public.

The Commission considers that retaining the current arrangements would confer certainty and stability to the Victorian gas industry. This would assist commercial decision making by facilitating an environment conducive to new entry and investment. In the absence of certainty and stability, it would be more difficult for market participants to assess the viability of entry and investment, and this might render them less likely to undertake such activities.

The Commission also accepts that since substantial investment, both public and private, has been made in a system that clearly works, it is an efficient outcome to allow that system to continue. Utilisation of the PTS under the market carriage paradigm, by maintaining the investment made to date, represents the most efficient use of existing resources

A decision not to authorise the MSOR is likely to disrupt the industry and lead to significant uncertainty. By avoiding this disruption, and the efficiency likely to result from it, the continued authorisation of the MSOR results in public benefits.

If the MSOR were not authorised, significant disruption to the Victorian industry would be likely to occur. This industry has recently been deregulated and pro-competitive reforms have been implemented, including the MSOR. The continued development of a more competitive and efficient gas industry could be delayed if the MSOR were not authorised. For example, significant resources would need to be focussed on alternative arrangements which would detract focus from other areas of the industry where further competition is required.

The Commission considers that maintaining consistency with current arrangements would result in a benefit to the public.

Facilitate retail competition

In the 1998 Determination, the Commission expressed the view that the MSOR would facilitate retail competition. This is primarily because AMDQ is assigned to end users, who retain their AMDQ if they change retailers. A retailer that wins a customer from another retailer also obtains the capacity rights of that customer. It is therefore not necessary to enter into transportation contracts with the pipeline owner as in a contract carriage system.[120] This

[120] ACCC 1998 Determination p. 24.

is particularly beneficial when the pipeline is fully contracted, which the PTS probably would be under contract carriage.

The Commission considers that this analysis remains valid. The market carriage system facilitates retail competition by significantly reducing the difficulties faced by retailers under contract carriage in gaining access to transmission capacity.

The Commission also said that in the absence of the MSOR, retail contestability is likely to be limited.[121] This appears to be the case, as potential retail entrants in states with contract carriage systems have experienced significant difficulty gaining access to transmission capacity. VENCorp's argument in relation to the impediments to customer churn on the Western Transmission System also supports this conclusion.

A number of aspects of the MSOR facilitate retail competition and new entry into the Victorian gas industry. For example, AMDQ and AMDQ credit are now fully tradeable, giving new retailers the ability to acquire these transmission rights directly. The transparency of the MSOR, and VENCorp's provision of market information, are other factors likely to facilitate entry into the retail market. This is because they assist potential entrants in making informed decisions regarding the viability of entry.

However, the scope for new entry into the retail market is constrained somewhat by the inability of new entrants to obtain gas supplies from producers. The Commission understands that prospective retailers have experienced difficulty obtaining competitively priced gas supplies from Bass Strait producers, and that the capacity of the Interconnect limits the amount of gas that can be sourced from the Cooper Basin. While these factors are not related to the MSOR, the Commission notes that competition upstream would also facilitate more effective competition in the retail market. The ability to trade gas on the spot market could also facilitates retail competition. Where retailers have contracts with producers and then subsequently lose a customer, they will have excess gas. At the same, a retailer who wins a customer will require additional gas. Rather than negotiate new contracts with producers, the retailer with surplus gas could sell that gas on the spot market, and retailers requiring additional gas could acquire it.

Nevertheless, evidence suggests that the Victorian retail market is competitive. Churn rates of 25 per cent for customers acquiring more than 10 TJ demonstrate that customers have a range of choices and are willing to switch retailers, and that retailers are actively competing for customers. The successful entry of an independent retailer, Energex, in 1999, also supports the view that the Victorian retail market is competitive. The Commission considers that the MSOR have facilitated the existing level of retail competition, primarily via the use of AMDQ credit assigned to end users.

In its 1998 Determination the Commission also noted that retail competition is important for the benefits of the MSOR and other competitive reforms to be passed onto consumers.[122] The Commission stated that the threat of losing customers to rivals would improve the overall efficiency and consumer benefit in the following ways:

- by providing retailers with incentives to minimise costs, including the cost of gas supply; and

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[121] ACCC 1998 Determination p. 24.

[122] ACCC 1998 Determination p. 24.

- by encouraging retailers to develop innovative product packaging and pricing which:

– better meets the demand profile and other requirements of particular classes of customers;

– encourages and rewards demand side management including customer management of interruptible loads; and

– allocates or shares risk and incentives between retailers and end customers.

In conclusion, the Commission is of the view that the MSOR delivers public benefits by facilitating retail competition.

Harmonisation of energy markets

VENCorp is claiming that two additional benefits result from the MSOR:

- it facilitates the development of a national gas market; and

- it facilitates harmonisation of gas and electricity markets, particularly through promoting gas-fired electricity generation.

The factors that VENCorp claims will give rise to this benefit have all been raised elsewhere as public benefits in themselves. The Commission does not accept the facilitation of interstate trade as a benefit, but does accept that greater transparency of pricing does occur under the MSOR. Whether these characteristics will facilitate the development of a national gas market is at this time a matter of conjecture only.

The Commission notes Duke Energy's intention to construct a trading hub to facilitate trade of gas between NSW, Victoria, South Australia and Tasmania. If VicHub does eventuate, and prices on it mirror the spot price in Victoria, this does not necessarily demonstrate benefit flowing from the MSOR.

The Commission considers there is some possibility that the emergence of a national gas market may be facilitated by the transparent pricing of, and ease of access to, the PTS, as provided by the MSOR. However, there is little evidence of this trend, and accordingly the concomitant likely public benefit is slight.

The Commission is also uncertain that the MSOR facilitate increased gas-fired electricity generation. The Commission notes submissions by TXU to the effect that single zone daily pricing disadvantages gas-fired generation. This is principally because:

- gas-fired generators need to respond to half-hourly pricing signals in the NEM, but are reliant on an *ex post* daily price for gas; and

- gas-fired generators are listed in Table 1 of Gas Load Emergency Curtailment Rules, which means that they are among the first users to be curtailed in the event of a system constraint.

The second point is particularly telling. Gas-fired generators are generally designed to provide peaking capacity, to take advantage of high prices in the NEM when they occur. If those high prices occur during an episode of constraint on the PTS, gas-fired generators face curtailment, as occurred on 22 July. This situation is likely to act as a disincentive to investment in gas-fired generation. However, the Commission acknowledged that there has

been investment in gas-fired generation of late, although it is unclear whether this is attributable to the MSOR.

If VENCorp decides to introduce locational hourly pricing, this should rectify these issues in large part. Once this has occurred, it may transpire that market carriage facilitates the uptake of gas-fired generation. However, at this point in time such an eventuation is difficult to predict.

Accordingly, the Commission considers that the MSOR may in the long-term give some assistance to the harmonisation of energy markets. However, this claimed benefit is backed by insufficient evidence, and its realisation is contingent on factors such as how markets elsewhere develop, and the likely effects of locational hourly pricing, should it be introduced. Thus the Commission cannot accept the harmonisation of energy markets as a significant public benefit at this point in time.

6.2 Anti-competitive detriments

The MSOR essentially govern two activities: systems operation of the PTS, and operation of the spot market in Victoria.

Several sections of the MSOR relating to market operation could potentially raise issues under the TPA. For example, the provisions relating to value of lost load (VoLL)(clause 3.2.4), and those relating to withdrawal and allocation algorithms (clause 3.5).

VoLL could be interpreted as an agreement on price between market participants. In this sense it could raise issues under sections 45 and 45A of the TPA.

Clause 3.5.2 requires an allocation agent to be appointed at an injection point being used by multiple parties. This could potentially raise issues under section 47 of the TPA.

The spot market involves agreement between all market participants on matters such as:

- how much gas is injected and withdrawn by market participants;
- what price market participants will pay or receive for gas; and
- how the market will operate in emergencies.

Under the TPA, agreements between competitors on price are deemed to lessen competition. Other agreements between competitors may also infringe the TPA, if their effect is to lessen competition. Accordingly, these aspects of the MSOR are likely to raise issues under Part IV of the TPA.

In Victoria, gas imbalances are traded on the spot market. Chapter 2 of the MSOR requires the following classes of people to register with VENCorp as participants:

- transmission pipeline owners;
- interconnected pipeline owners;
- producers;
- transmission customers;
- distributors; and
- storage providers.

These participants are required to pay market fees to VENCorp under clause 2.6.

This system, which operates on a compulsory basis, may be less competitive than if all parties were free to trade gas and negotiate prices independently.

In this section, the Commission assesses the extent to which, by lessening competition, the MSOR results in detriment to the public. This will be considered in relation to the specific issues raised by the applicant and interested parties.

6.2.1 Market Intervention and Force Majeure

VENCorp's powers in relation to intervention and market suspension are outlined in Chapter 6 of the MSOR. Chapter 6 creates a hierarchy of situations warranting intervention as follows:

- emergency;
- threat to system security; and
- force majeure and market suspension.

Chapter 6 confers a range of powers on VENCorp to address each particular situation. These include directing market participants to withdraw or inject gas. In a situation that constitutes force majeure, VENCorp may suspend the operation of the market and determine the market price.

Applicant's submission

VENCorp submits that since 1999, it has not had to intervene in the market to resolve any emergency, despite numerous stresses to the system.[123] This submission was made prior to VENCorp's intervention in the market on 22 July 2002. On this occasion VENCorp declared a Level 5 Emergency, and required customers to curtail gas as per the Gas Load Emergency Curtailment Rules.[124]

VENCorp considers that the current force majeure provisions replicate a reasonable commercially negotiated position.[125]

Interested parties' submissions

Esso submits that:

- the MSOR do not give enough protection to market participants, especially producers, in relation to the occurrence of typical force majeure events;
- this provides additional risk to producers bidding into the market, and acts as a disincentive to investment; and
- there is no specific provision allowing interruptible gas to be bid into the pool.[126]

Applicant's response

VENCorp responds to Esso's comments as follows:

- there could be 'significant market issues' if parties who bid in gas for a day were subsequently permitted to revise their bids;[127]
- the introduction of a locational hourly pricing model could facilitate the injection of interruptible gas;

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123 VENCorp submission 20 May 2002 p. 55.

124 These are published by VENCorp on its website pursuant to clause 6.4.3 of the MSOR.

125 VENCorp submission 20 May 2002 p. 56.

126 Esso submission 19 July 2002 pp. 6-7.

127 VENCorp submission 20 May 2002 p. 20.

- VENCorp is willing to discuss with Esso any proposal to provide for gas to be provided on a non-firm basis;[128]
- producers would face greater flexibility and less risk under an hourly spot market; and
- Esso is able to address these concerns through the rule change process.

Issues arising since the Draft Determination

Following release of the *Draft Determination*, Esso wrote to the Commission on 8 November 2002.

Esso reiterated three areas of concern it discussed in its submission to the Commission of 8 November 2002. These were:

- force majeure relief from scheduling instructions;
- the balance of liabilities for participants; and
- the ability of producers to bid non-firm gas into the spot market.[129]

In relation to the first issue, Esso indicated its support for the amendment proposed by the Commission insofar as it included *force majeure* situations among those in which participants could be excluded from liability. However, Esso considered that the ability of market participants to obtain relief under this clause should not depend on VENCorp's opinion.[130]

In relation to the second issue, Esso considered that the liability of market participants should be limited to direct damages only. Esso also considered that market participants should not be liable for off-specification gas accepted by VENCorp.[131]

In relation to the third issue, Esso submitted that the Commission should require VENCorp to develop and include appropriate amendments to cover the issue of nominations for non-firm gas.[132]

Commission's considerations

In its *Draft Determination*, the Commission considered that clause 3.1.13(d)(1) of the MSOR should be amended to reflect Esso's concerns. Clause 3.1.13(d)(1) currently reads:

> due to a technical fault or failure which, in the opinion of VENCorp, was outside the Market Participant's control;

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128 VENCorp submission 19 August 2002 pp. 20-21.

129 Esso submission 8 November 2002 p. 1.

130 Esso submission 8 November 2002 p. 1.

131 Esso submission 8 November 2002 p. 1.

132 Esso submission 8 November 2002 p. 1.

Accordingly, the *Draft Determination* proposed the following condition of authorisation:

C6.1 It is a condition of authorisation that clause 3.1.13(d)(1) be amended to provide, relevantly:

due to a technical fault or failure or *force majeure event* which, in the reasonable opinion of VENCorp, was outside the *Market Participant's* control.

This clause is to be read subject to the obligations placed on *Participants* by clause 6.7.2.

This amendment must be implemented at the expiration of a period of six months after the Commission releases its Final Determination on VENCorp's application, unless either Esso or VENCorp submits rule change proposals to the GMCC that address Esso's concerns in relation to the liability of Participants in situations generally considered to be force majeure events.

Since the release of the *Draft Determination*, VENCorp and Esso have indicated to the Commission they are currently negotiating in relation to this issue with a view to formulating rule change proposals. The Commission, whilst cognizant of this continuing process of negotiation, considers nonetheless that the inclusion of a condition of authorisation in relation to this issue has merit, as it would encourage the parties to arrive at a mutually acceptable view on this issue in an expeditious manner.

However, the Commission considers it may be appropriate to remove the words 'in VENCorp's opinion' from clause 3.1.13(d)(1), rather than amending them to 'in VENCorp's reasonable opinion'. As a result, the availability to market participants of relief under this clause in force majeure situations would not depend on VENCorp's opinion. Rather, it would depend on the interpretation of the clause by a third party, such as a dispute resolution panel appointed under clause 7.2 of the MSOR.

Whether a condition of authorisation is imposed depends of the Commission's assessment of the overall balance of benefit and detriment in relation to the MSOR. This is discussed in section 8 of this *Final Determination*.

In relation to the potential for amendments to the MSOR to permit producers to bid interruptible gas into the PTS, the Commission considered in the *Draft Determination* that such provisions could provide benefits. However, the Commission noted that a number of other issues would need to be addressed in relation to this matter. These were:

- on what basis rebidding would be permitted – for example, technical reasons, commercial reasons, force majeure events etc;
- the implications for system integrity of changing bids within a day; and
- any further issues that VENCorp or market participants might consider relevant.

The Commission believes that these considerations remain important, and would need to be resolved before interruptible gas could be injected into the PTS. Accordingly, the Commission considers that VENCorp and Esso should continue their negotiations on this matter.

Given the interrelation between this issue and locational hourly pricing, the Commission considers that any review of the current pricing mechanisms on the PTS should also consider the possibility of allowing gas producers to rebid during the day. This is discussed in section

6.2.11 of this *Final Determination*. When the issue of interruptible gas is considered, attention should be given to the problems that have arisen in the NEM in relation to rebidding by generators. It is important that any gas market solution does not give rise to analogous concerns.

In relation to Esso's submission that the liability of market participants should be limited to direct damages only, Esso has provided no evidence that an adjustment of the liability of market participants in this manner would be beneficial to the operation of the system as a whole.

Furthermore, the Commission does not consider it appropriate to require VENCorp to make amendments in relation to the liability of market participants in relation to off-specification gas. There would clearly be issues relating to the safety and integrity of the PTS associated with any such changes. Therefore this issue is best left to the rule change process.

6.2.2 AMDQ allocation

AMDQ confers a right on a participant to withdraw a specified amount of gas from the PTS. The bulk of AMDQ rights were initially allocated to gas customers. AMDQ credit, as defined currently by the MSOR, may be utilised by its holder as an uplift hedge. Essentially, on most days there is adequate capacity on the PTS for all deliveries. When congestion occurs on the PTS, users may face uplift charges. AMDQ credit may be utilised to protect the holder from these uplift charges.

When amendments to the MSOR (that have been approved by VENCorp's Board of Directors, the GMCC, and authorised by the Commission) come into effect, AMDQ credit will also be able to be used to establish a curtailment priority in the event of threats to system security.[133]

The procedures for allocating, relinquishing and trading AMDQ and AMDQ credit are outlined in clause 5.3 of the MSOR.

Applicant's submission

VENCorp makes the following points in relation to AMDQ allocation:

- AMDQ is now fully transferable;
- shippers are generally able to transport quantities in excess of their AMDQ; and
- the current arrangements facilitate new entry because entrants do not need to book capacity.[134]

Interested parties' submissions

TXU comments that:

- customers appear reluctant to relinquish AMDQ they are not using; and
- shippers cannot obtain access to spare transportation capacity at non-peak times, such as summer.[135]

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[133] The date for implementation of these changes is to be advised: see www.vencorp.com.au.

[134] VENCorp submission 20 May 2002 pp. 58-9.

In addition to advocating a move to locational hourly pricing as a solution to these problems, TXU also proposes the following measures:

- providing incentives for customers to release AMDQ they are not using; and
- reviewing the model for allocating Tariff V AMDQ for periods when it is not used, such as summer.[136]

Energex argues:

- AMDQ is over valued, which reduces the value of AMDQ credit; and
- the extent of this problem will be determined by the size of injections into the market from sources other than Longford.[137]

Duke Energy submits:

- uplift payments should be included in the pool price, rather than relying on AMDQ and AMDQ credit;
- the ACCC should review the uplift payment mechanism, and the allocation of AMDQ and AMDQ credit within the market;
- an advantage accrues to incumbent retailers due to the higher price of obtaining AMDQ credit; and
- AMDQ and AMDQ credit are a 'cumbersome and expensive mechanism to control capacity within the pipeline network'.[138]

Applicant's response

In its response to TXU's comments, VENCorp makes the following points:

- similar issues arise on contract carriage pipelines, where shippers seem reluctant to release property rights, and therefore this appears to be an issue of retailer/customer relations;
- retailers should be able to re-obtain AMDQ by offering customers a re-packaged deal; and
- this issue does not indicate fundamental problems with the MSOR, and could be addressed under the rule change process.[139]

Issues arising since the Draft Determination

Energex raised several issues at the predetermination conference in relation to AMDQ.

Firstly, Energex submitted that the *Draft Determination* was incorrect in stating that AMDQ was originally allocated to end user customers, as 3.5 TJ per day was also allocated to the owner of the PTS.

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135 TXU submission 17 July 2002 p. 9.

136 TXU submission 17 July 2002 p. 9.

137 Energex submission 17 June 2002 p. 14.

138 Duke Energy submission 13 May 2002 p. 4.

139 VENCorp submission 19 August 2002 p. 14.

Secondly, Energex submitted that the *Draft Determination* was incorrect in stating that AMDQ is fully transferable and tradeable. This is because AMDQ is allocated to Tariff V customers as a block of 640 TJ, and it is not possible for Tariff V customers to identify their individual portion of AMDQ. Energex also submitted that an individual's share of this block varies as a proportion of total Tariff V usage.

Energex submitted there is a need to examine how AMDQ is allocated to both Tariff V and Tariff D customers.

Energex also submitted that, contrary to the view expressed in the Commission's *Draft Determination*, AMDQ cannot be used for gas from sources other than Longford. Energex also submitted that AMDQ cannot be used to hedge against ancillary payments, but can only be utilised as a hedge against uplift.

In its submission of 5 December 2002, Energex reiterated that the AMDQ held by Tariff V customers is not transferable or tradeable because these customers hold their AMDQ as a block, and their share is determined by individual withdrawals as a proportion of the whole on the day of a constraint.[140]

Commission's considerations

The Commission is broadly in agreement with VENCorp's submissions on AMDQ. The Commission supports VENCorp's initiative to make AMDQ transferable, and takes the view that the current level of transferability and tradability in relation to AMDQ has the potential to facilitate the entry of gas buyers into the Victorian market.

The Commission appreciates TXU's concern that some customers appear reluctant to relinquish AMDQ for periods when they are not using it. The Commission also notes the views expressed by VENCorp on this matter in its Review of Victorian Gas Market Arrangements (2001). This review stated:

> Additionally, should locational hourly pricing and additional rights models not be implemented, AMDQ should be further developed to permit:
>
> – Review of the allocation of Tariff V AMDQ, including potential for the reallocation of the AMDQ currently reserved for but not required by tariff V customers over summer, relative to requirements and capacity…[141]

The Commission notes that TXU and VENCorp appear to agree that this measure is only necessary as long as pricing is determined on a single zone, daily basis. Therefore if VENCorp decides to implement changes to the pricing mechanism on the PTS, such as the introduction of locational hourly pricing, this change should not be required. However, if such changes do not occur, the Commission considers that this issue merits further review, as discussed later in this section.

In relation to Duke's comments, the Commission does not consider that, under the current arrangements, uplift payments should be included in the pool price. This would not provide market participants with sufficient incentive to conform to transmission constraints. However, if uplift payments were included in a single zone daily pool price, this would amount to smearing the costs of uplift across all users, and would not provide the appropriate incentive for gas users to remain in balance.

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[140] Energex submission 5 December 2002 pp. 4-5.

[141] Review of Gas Market Arrangements (2001) p. 33. See www.vencorp.com.au.

Duke's proposal might be more feasible should locational hourly pricing be introduced.

In its *Draft Determination*, the Commission considered that Energex' concerns were alleviated by the tradability of AMDQ and AMDQ credit.[142]

Following discussions with interested parties, the Commission considers that there may be some distortion in the relative valuations of AMDQ and AMDQ credit if the amount of gas injected at Longford decreases substantially. This could result in a situation where some participants hold the right to withdraw gas in the form of AMDQ, but are not actually injecting gas into the PTS. This situation could diminish the value of AMDQ credit, since AMDQ credit accrues only to the extent that gas is actually injected into the pipeline.

The Commission also agrees with Energex that the allocation of AMDQ to Tariff V customer as a block creates problems for the tradability of this capacity right, which in turn affects the ability of retailers to obtain capacity. The volume of customer churn may also be adversely affected.

In relation to both these issues, the Commission notes firstly that it has recommended that VENCorp should consider adjustments to the current arrangements relating to AMDQ, should it conduct a review into the current pricing mechanism on the PTS. This issue is discussed at section 6.2.11 of this *Final Determination*. If VENCorp conducts this review, it would probably be necessary to make substantial changes to the configuration of AMDQ and AMDQ credit. If such changes are introduced, the criticisms made of AMDQ by TXU and Energex may become less relevant.

If VENCorp ultimately decides not to alter the current pricing mechanisms, some further changes to the current AMDQ and AMDQ credit regime appear necessary. Therefore if no alterations to the current pricing mechanisms occur following VENCorp's review, the Commission recommends that VENCorp review the current arrangements in relation to AMDQ. This review should consider the following issues:

- whether there is sufficient tradability and transferability of AMDQ rights;
- whether there is any current or likely future mismatch in the relative valuation of AMDQ and AMDQ credit;
- the detrimental impact of the failure of the current regime of ancillary payments and uplift payments to deliver firm capacity rights;
- whether particular classes of users, such as gas-fired generators, are prejudiced by the current regime of AMDQ and AMDQ credit; and
- whether the current regime of AMDQ and AMDQ credit is the most effective means, compatible with full retail contestability and multiple injection sources, of conferring transmission rights on the PTS.

The Commission stresses that this review should only be required if no adjustment is made to the current pricing mechanism on the PTS.

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[142] ACCC Draft Determination p. 42.

6.2.3 Concerns relating to capacity rights

Several interested parties have indicated that firm capacity rights, which shippers and producers can usually obtain under a system of contract carriage, cannot be obtained under the MSOR. This is for a number of reasons, including the threat of curtailment and uplift payment, and the availability of AMDQ and AMDQ credit.

Interested parties' submissions

Esso submits in relation to this issue:

- market participants can only obtain firm capacity rights through paying for a pipeline extension or expansion;
- accordingly, gas sellers cannot offset risk by contracting firm capacity rights; and
- this may cause problems for sellers outside Victoria selling into Victoria, particularly where AMDQ is transferred from a customer or between retailers.[143]

Esso also submits that upstream development is currently being constrained by the inability of shippers to underpin investment with long term sales contracts. Esso indicates that such arrangements would allow producers to offset the risk of investment, and apportion liability for risks appropriately between parties.[144]

TXU also comments on the inability of shippers to obtain firm capacity rights. TXU links this to single zone daily pricing, under which shippers are exposed to the risk of surprise uplift. The Commission's views on this matter are dealt with under the section dealing with single zone daily pricing.

Applicant's response

VENCorp makes the following responses in its submission of 19 August 2002:

- it is incorrect to state that market participants cannot obtain firm capacity, because AMDQ is transferable and tradeable;
- significant buyers of gas such as AGL, Origin and Energex did not raise the issue;
- AMDQ credit is available for interstate injections into the PTS; and
- the divergence between the systems of NSW and Victoria does not hinder interstate trade, as evidenced by flow volumes of gas across the Interconnect at Culcairn.[145]

Issues arising since the Draft Determination

At the predetermination conference, the Institute of Public Affairs (IPA) argued as follows:

- users cannot contract for capacity to obtain priority for carriage on the pipeline;
- users also have no recourse if gas is not delivered; and

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143 Esso submission 19 July 2002 pp. 3-4.

144 Esso submission 19 July 2002 p. 5.

145 VENCorp submission 19 August 2002 pp. 14-15.

- the inability to obtain firm capacity rights has contributed to the recent deferral of gas fired electricity generators such as Maryvale (Paperlinx/Duke 200 MW) and South Ballarat (AES 500 MW).

In its submission of 5 December 2002, TXU argues that a lack of firm capacity rights provides either insufficient incentive for pipeline expansions, or may possibly discourage them. TXU cites several reasons for this situation.

Firstly, TXU argues that AMDQ does not provide protection from surprise uplift, which currently constitutes the bulk of uplift payments.

Second, TXU claims that where a pipeline expansion is planned that will either export gas from Victoria or supply a gas-fired generator, the gas transported through that expansion that is destined either for export, or for supply to a gas-fired generator, will be assigned to Curtailment Table 1, and consequently be liable to curtailment.

Finally, TXU argues that other users may "free ride" a pipeline expansion, because they are able to take advantage of the increased capacity without sharing any of the investment risks.[146]

In addition to the introduction of locational hourly pricing, TXU advocates the introduction of Financial Transmission Rights (FTRs) as a means of providing firm capacity.[147]

Energex submits that it is misleading to say that gas-fired generators are listed in Table 1 of the Gas Load Emergency Curtailment Rules, because gas-fired generators can attract AMDQ credit and thereby gain a priority in load shedding events.[148]

Commission's considerations

In relation to Esso's arguments, it should firstly be pointed out that producers and retailers or customers are free to enter into contracts for the sale of gas under the current arrangements in Victoria. In fact, the majority of gas in Victoria is traded under contracts.

Although the bulk of AMDQ and AMDQ credit was originally allocated to end use customers, there is some tradability and transferability of these instruments. Furthermore, the Commission sees merit in the allocation of AMDQ and AMDQ credit to end use customers, as this facilitates retail competition.

It is conceded that these do not constitute a truly firm capacity right because a participant holding AMDQ or AMDQ credit may still be liable for uplift payments. This component of uplift payments not attributable to a transmission constraint is described in clause 3.6.8(k) of the MSOR and is generally known as 'surprise uplift'.

Although participants cannot obtain completely firm capacity rights, the quantum of surprise uplift to date has been modest.[149] Furthermore, if VENCorp were to introduce a locational hourly pricing regime, this would either eliminate or substantially reduce the risk of uplift. The Commission's discussion of the locational hourly pricing issue is contained in section 6.2.11 of this *Final Determination*. However if this pricing mechanism is not introduced, the

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146 TXU submission 5 December 2002 pp. 3-5.

147 TXU submission 5 December 2002 pp. 4-5.

148 Energex submission 5 December 2002 p. 4.

149 Uplift to date has totalled around $1.1m, according to VENCorp's submission of 20 May 2002 p. 54.

Commission has recommended that VENCorp address this issue as part of a review into the current method of allocating transmission rights on the PTS.

However, the scenario discussed by Esso in relating to shipping gas interstate could eventuate. Having obtained firm capacity rights on an interstate pipeline, a shipper could lose a customer and their AMDQ, and be left with the firm capacity rights on the interstate pipeline.

There are several points that should be made in relation to this issue. Firstly, this is a problem for retailers and customers rather than producers. This is because it is retailers who contract with a pipeline owner to obtain capacity. This issue has not been raised by retailers as a compelling concern in Victoria.

Furthermore, this problem would exist equally under contract carriage, particularly after full retail contestability is introduced. Having obtained firm capacity, the retailer could then lose its end customers, and be left with unneeded capacity.

The Commission addressed the issue of compatibility between the Victorian system and contract carriage systems outside Victoria in its 1998 Determination. The Commission commented on this issue:

> Interested parties operating pipelines in North America have noted that even though there is a common transportation model in North America, the details of carriage on each pipeline are different, but this has not prevented gas markets from developing.[150]

The Commission considers that the substance of this argument continues to apply. In addressing this matter, VENCorp quotes the Australian Gas Association's submission to the CoAG Energy Market Review of 2002:

> 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.[151]

Accordingly, the Commission considers that the concerns raised by Esso do not constitute a significant public detriment.

In relation to IPA's concerns relating to the inability of participants to obtain firm capacity rights, the Commission considers that the current arrangements in relation to capacity rights confer benefits, in the form of assisting retail contestability, as well as costs, such as a lack of firm capacity rights.

At this time, the Commission considers that the benefits outweigh the costs. There are clear benefits in providing a system of capacity rights that facilitates the transfer of customers between retailers. However, the Commission has noted several deficiencies with the current capacity rights regime provided by the MSOR, and has recommended these be reviewed in the event that adjustments to the current pricing mechanism do not occur.

In relation to IPA's comments about the deferral of recent gas-fired generation projects, the Commission notes that the decision whether or not to proceed with projects of this nature

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150 ACCC 1998 Determination p. 44.

151 VENCorp submission 20 May 2002 p. 37.

generally depends on a wide range of factors and contingencies, and it is often difficult to ascertain the principal reason, among many, for the discontinuation of a project. Furthermore, the Commission notes the recent commissioning of the Somerton (150 MW) and Valley Power (300 MW) gas-fired generators.

In relation to Energex' submission of 5 December 2002, the Commission agrees that if a constraint is attributable to a participant(s) using in excess of its (their) AMDQ, then that or those customers will be curtailed before those holding AMDQ or AMDQ credit. However, it is questionable how much protection this affords to gas users listed in Table 1 of the Gas Load Emergency Curtailment Rules, such as gas-fired generators. At most it means that some limited class of users may be curtailed before they are.

The Commission acknowledges TXU's concerns in relation to involuntary curtailment. However, the Commission considers that the Gas Load Emergency Curtailment Rules are designed to maximise the safety of the PTS and are therefore justified.

In relation to TXU's concerns of free riders, the Commission notes that while users of gas might take advantage of another user's pipeline expansion, they would not receive the AMDQ or AMDQ credit in relation to that expansion. This modifies the free rider issue, although it does not eliminate it entirely.

In relation to TXU's submission that FTRs should be introduced for the PTS, the Commission considers that while this suggestion appears to have some merit, it should be discussed widely among interested parties before a move towards its implementation. To commence this process, the Commission suggests that TXU submit rule changes to the GMCC.

6.2.4 Value of Lost Load (VoLL)

Section 3.2.4 of the MSOR establishes a price cap (VoLL) of $800/GJ on gas.

Applicant's submission

VENCorp submits that the public benefit from VoLL continues to outweigh any accompanying anticompetitive detriment. VENCorp also argues that:

- VoLL provides a price signal that assists risk management and investment decision-making;
- VoLL assists the market in its transition from a centrally planned monopoly to a dynamic market; and
- the highest price to date has been $5.45/GJ, well below the $800/GJ at which VoLL is set.[152]

Interested parties' submissions

Energex submits that VoLL is appropriately valued at this time.[153]

EUAA argues that the current VoLL is determined on the basis of a locational hourly pricing paradigm, and exposes end users and participants to significant financial risk. EUAA

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[152] VENCorp submission 20 May 2002 p. 57; however since this submission was made, a price of $9.20 was reached on 22 July 2002.

[153] Energex submission 17 June 2002 p. 14.

suggests that VoLL should be substantially lowered, and that this could occur without significant risks to investment or demand management.

Issues arising since the Draft Determination

At the predetermination conference, EUAA suggested there is currently no sound basis for the level of VoLL, and that VoLL at its current level could bankrupt the market.

In its submission of 5 December 2002, VENCorp submits that EUAA's demands should be satisfied by the two-year review of VoLL, as currently prescribed by clause 3.2.4(d) of the MSOR.[154]

Commission's considerations

The Commission is not convinced that VoLL should be lowered. A lower VoLL would represent increased interference in market mechanisms, which might defeat the overall purposes of market carriage. A lower VoLL might also mask signals to efficient investment.

In its 1998 Determination the Commission considered that the public benefit of VoLL outweighed any concomitant anticompetitive detriment.[155] The Commission considered that VoLL protected customers from price spikes, and that its price was set sufficiently high to avoid distorting the market. The Commission did, however, require that reviews of VoLL take place every two years.

The reasons underlying the views expressed by the Commission in 1998 continue to exist; accordingly the Commission considers that the concept of VoLL, at its current valuation, continues to represent a net public benefit. Since VoLL has not been reached since market commencement, it would be difficult to argue that it has caused distortion to the market.

The Commission also notes that on 22 July 2002, the price of gas was $9.20 GJ, well short of VoLL. This indicates that VoLL is unlikely to be reached, and the prospect of the market being bankrupted appears remote.

Furthermore, because there are currently no major problems with VoLL at its current level, there is insufficient justification for reviewing VoLL with a view to arriving at some level with a stronger theoretical or empirical basis. It is unlikely the cost of such an exercise could currently be justified. VoLL is currently reviewed every two years; this should suffice.

The Commission considers that VENCorp should continue reviewing VoLL every 2 years, given the significant change presently occurring in this industry, such as the anticipated introduction of new gas sources and the increasing uptake of gas-fired generation.

6.2.5 Limitation of VENCorp's liability

Under the MSOR, VENCorp's liability is limited by the following clauses:

- clause 1.2.2, which provides a general limitation on VENCorp's liability, except to the extent otherwise provided for by the MSOR;

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[154] VENCorp submission 5 December 2002 p. 5.

[155] ACCC 1998 Determination p. 96.

- clause 3.1.6, which relates to title to gas and provides that each participant must indemnify VENCorp but that VENCorp is not liable in the event that a participant breaches its warranty as to title;

- clause 4.4.26, which provides that VENCorp shall not be liable for metering errors, including those relating to metering data that is stored in the metering database;

- clause 5.4.4, which provides that participants must indemnify VENCorp for any breach of the confidentiality provisions;

- chapter 6, which relates to intervention and market suspension, and provides that VENCorp will not be liable for any loss incurred by a participant as a result of any action taken by VENCorp pursuant to these provisions (clause 6.1.3); and

- under the dispute resolution provisions, to the extent permitted by law, the dispute resolution adviser, the panel and its members do not incur liability for any act or omission unless they fail to act in good faith (clause 7.2.12).[156]

Applicant's submission

VENCorp claims that:

- market participants unanimously considered that any review of VENCorp's liability was unnecessary;

- the Participant Compensation Fund (PCF) currently imposes no charge on participants, and no claims have been made against the fund since market commencement;

- VENCorp has consistently demonstrated competence and accountability in its actions; and

- VENCorp's actions are subject to considerable scrutiny from bodies including the Victorian Auditor-General's office, the Victorian State Government Treasury and the Office of Gas Safety.[157]

Interested parties' submissions

Esso comments:

- there is asymmetrical protection for different classes of participants under the MSOR and the Gas Industry Act – retailers and transporters have some protection, gas producers have none, while VENCorp's protection is total;

- this acts as a disincentive to new producers entering the market; and

- these inconsistencies are particularly evident in relation to scheduling nomination and off-specification gas.[158]

In relation to scheduling nominations, Esso submits that VENCorp's liability is limited to the amount that can be recovered from the PCF. Likewise, Esso argues that VENCorp's liability

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156 See ACCC 1998 Determination p. 49.

157 VENCorp submission 20 May 2001 pp. 59-61.

158 Esso submission 19 July 2002 pp. 7-8.

in relation to off-specification gas is limited by clause 1.2.2 to the amount that can be recovered from the proceeds of insurance.[159]

Energex expresses concern that the current arrangements shift liability from VENCorp to market participants. Energex considers that, given this, industry participants should be better represented on VENCorp's board. Specifically, Energex notes that only three out of ten members of the VENCorp board are market participants, and argued that VENCorp's board needs to include a separate representative for independent retailers.[160]

EUAA argues that VENCorp should be made more accountable for its actions. EUAA indicates that if actual liability were not imposed on VENCorp, an alternative might be to include an end user representative on VENCorp's board.[161]

EAG also argues that VENCorp needs to be more accountable, and that at present VENCorp has insufficient incentive to minimise market risk. EAG considers that VENCorp should be liable for poor decision making or dispatch allocation.[162]

Applicant's response

In response to these views, VENCorp makes the following points:

- other pipeline systems generally involve comprehensive exclusions of liability of the operator;
- any costs incurred by the systems operator in the form of liability will ultimately be passed on to end use customers;
- the fact that as yet no claims have been made on the participant compensation fund indicates that VENCorp does not bear an acceptably low level of liability; and
- the liability provisions could be adjusted through the rule change process, but this is not a major issue for most industry participants.[163]

Commission's considerations

In its 1998 Determination, the Commission identified a number of concerns arising from the VENCorp's limited liability:

- it might lead to moral hazard, or to put it another way, VENCorp might develop a 'culture of immunity';
- it might constitute a barrier to entry due to the high cost to market participants of obtaining adequate insurance; and
- costs to market participants of the PCF might constitute a barrier to entry.[164]

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159 Esso submission 19 July 2002 pp. 7-8.

160 Energex submission 17 June 2002 p. 15.

161 EUAA submission 6 August 2002 p. 6.

162 EAG submission 19 August 2002 p. 7.

163 VENCorp submission 19 August 2002 pp. 21-22.

164 ACCC 1998 Determination p. 50.

The Commission considers there is no evidence that VENCorp has developed a 'culture of immunity'. From the Commission's discussions with interested parties it appears that VENCorp carries out its functions in an appropriate manner. DNRE endorsed this view, commenting:

> The Government considers that VENCorp has performed its functions satisfactorily to date.[165]

The Commission also considers that the costs of the PCF do not constitute a barrier to entry. As noted in VENCorp's submission of 17 May 2002, no claims have been made to date on the PCF, and further contributions have been halted.[166] VENCorp has also indicated that there is currently no charge to participants associated with the PCF.[167]

The Commission makes several observations in relation to the risks faced by market participants using the PTS.

Under a contract carriage system, it is likely that the pipeline owner as systems operator would limit their liability either absolutely, or in all cases other than those involving wilful negligence or default.

Furthermore, in relation to Esso's arguments regarding the balance of liabilities imposed by the Gas Industry Act, the Commission notes that it is unable to review the provisions of this Act. Therefore the extent to which the provisions of this Act might act as a barrier to entry is not a relevant consideration for the Commission.

As was discussed in the Commission's 1998 Determination, VENCorp's limited liability is unlikely to constitute an entry barrier unless the costs to market participants of obtaining insurance outweigh the increase in market fees that would occur if VENCorp were required to obtain the insurance itself. As discussed, the Commission has no evidence to suggest this is the case. Furthermore, this would be unlikely unless there were demonstrated some moral hazard on the part of VENCorp. Again, this has not been shown. Accordingly, the Commission considers that to date, VENCorp's liability has not imposed an entry barrier on potential market participants.

The issue of representation on VENCorp's Board of Directors is considered in the section dealing with end user advocacy issues.

Accordingly, the Commission considers that VENCorp's limited liability is unlikely to detract from the net public benefit arising from the operation of the MSOR.

6.2.6 End user advocacy issues

Interested parties' submissions

EUAA argues that several factors make it difficult for end-users to adequately comment on important issues. These include:

- the disparate nature of end users; and
- the lack of understanding by end users of how the market functions.

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[165] DNRE submission 14 August 2002 p. 3

[166] VENCorp submission 20 May 2002 p. 60.

[167] VENCorp submission 20 May 2002 p. 60.

EUAA suggests several measures that could be taken to improve end user participation. These include:

- the appointment of at least two end user representatives on VENCorp's board;
- the appointment of at least two end users as full participating members on the GMCC;
- a formal requirement for VENCorp to consult with end users in relation to proposed changes; and
- the introduction of end user advocacy funding.[168]

EUAA recommends that the Commission require the introduction of an end user advocacy funding scheme similar to that currently in place in the National Electricity Market (NEM). EUAA indicates that in the NEM, the funding is sourced from a slight increase in NEM fees.[169]

Likewise, EAG calls for end user advocacy funding similar to the arrangements in the NEM.[170]

Applicant's response

VENCorp submits that members of its Board of Directors are appointed by the Victorian Government under the Gas Industry Act. Accordingly, VENCorp considers this to be a matter of government policy.[171]

Issues arising since the Draft Determination

At the predetermination conference on 21 November 2002, EAG and EUAA renewed their call for a range of end user advocacy measures.

EUAA argued that the Commission's proposal that an end user representative be given voting rights on the GMCC, and then waiting to see what issues arise, is not an adequate response. EUAA submitted that this is because funding is necessary for end users to participate effectively in GMCC processes.

EUAA reiterated its call for end user advocacy funding, and again noted that such funding has been approved in relation to the NEM.

EUAA also submitted that the Commission should recommend that an end user representative be given a seat on VENCorp's board.

At the predetermination conference, VENCorp indicated it was willing to include an end user representative on the GMCC. However, VENCorp submitted that it is important to find a means of appointing an end user representative that ensures all end users are adequately represented.

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168 EUAA submission 6 August 2002 pp. 9-10.

169 EUAA submission 6 August 2002 p. 10.

170 EAG submission 19 August 2002 p. 5.

171 VENCorp submission 19 August 2002 p. 23.

Energex submits that:

- it is a good idea for consumer groups to make input on wholesale market issues;
- because of differences between the NEM and the Victorian gas market, the NEM approach to end user advocacy is not appropriate for Victorian gas markets;
- the question arises as to the extent to which end user organisations would represent end users as a whole, rather than their particular constituents;
- significant differences exist amongst commercial and industrial users; and
- it is appropriate for an end user representative to have a seat on the GMCC.[172]

At the predetermination conference, IPA expressed opposition to end user advocacy funding.

In its submission of 5 December 2002, VENCorp submits that:

- the proposal by end user advocacy groups to receive funding may present problems under the MSOR inasmuch as it would require VENCorp to seek recovery of funding provided to one particular interest group;
- the GMCC was formed to comply with the consultation requirements set out in the MSOR, but it is not mentioned in the MSOR, and therefore, strictly speaking, is not an authorisation issue;
- questions remain as to who an end user advocate would represent on the GMCC, and who they would be accountable to;
- the proposals of EUAA and EAG for end user advocacy funding would require significant infrastructure to implement and administer, as has occurred with the end user advocacy funding schemes of CUAC and NECA; and
- further funding for end user advocacy might duplicate the functions of CUAC.[173]

Commission's considerations

The Commission has considered the suggestions made by Energex and EUAA that VENCorp's Board of Directors should be modified to reflect the interests of various classes of market participants. The Commission notes that the appointment of VENCorp's directors does not occur under the MSOR, but rather under the Gas Industry Act. The Commission is not empowered to make recommendations of this nature. Furthermore, the Commission considers that the composition of VENCorp's Board of Directors is a policy matter for the Victorian government. The composition of VENCorp's Board has no direct bearing on whether the MSOR should be authorised, since it is the MSOR which is the subject of the authorisation application, rather than VENCorp.

In relation to the call by EUAA and EAG for voting rights on the GMCC, the Commission notes that the GMCC is not explicitly mentioned in the MSOR. Rather, this body was established by VENCorp to comply with the requirements of clause 8.3(b) of the MSOR.

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[172] Energex submission 5 December 2002 pp. 3-4.

[173] VENCorp submission 5 December 2002 pp. 5-6.

This clause provides:

> In considering a Rule change proposed by a person other than VENCorp, or before itself proposing a Rule change, VENCorp:
>
> (b) must consult with persons who VENCorp reasonably considers will be likely to be affected by the proposed Rule change…

Accordingly, while the constitution of the GMCC does not technically form part of the MSOR, it is a matter which has a direct bearing on the net benefit or detriment likely to result from the operation of the MSOR. While end user representatives are not themselves participants in the market, end users are clearly likely to be affected by decisions in relation to the MSOR. Therefore end users should have a voice in relation to such decisions.

Accordingly, the Commission suggests that VENCorp make provision for an end user representative to have a seat on the GMCC. This may not require explicit changes to the MSOR. The Commission recognises that this change may require further adjustments to the make up and voting procedures of the GMCC.

The Commission agrees with VENCorp that it is appropriate to devise a means for appointing an end user representative that would ensure that all end users are adequately represented. However, the Commission also considers that, given that EAG and EUAA have represented users during the authorisation process to date, a representative of either of these organisations would make an acceptable end user representative on the GMCC.

End user advocacy funding

The Commission notes that it has previously authorised end user advocacy in the NEM. In its *Determination* of 22 December 1999 in relation to an application for re-authorisation of the National Electricity Code (NEC), the Commission imposed several conditions of authorisation, the substance of which was to require the National Electricity Code Administrator (NECA) to conduct a review into the feasibility of end user advocacy funding.[174]

In its decision, the Commission cited several reasons why there was a need for advocacy funding in the NEM. The Commission noted that the NEM had been established primarily for the benefit of end users, who accordingly should have a formal process for input into its arrangements. The Commission also acknowledged that the resources of end user advocacy groups were inadequate to cover the many reviews conducted in the NEM. The Commission also noted that since end users were not Code participants, they were excluded from most of the NEM's formal consultation processes.

NECA subsequently conducted this review as required, and in it recommended that, among other things, users be given funding via the imposition of and end-user advocacy levy, and that an Advocacy Panel be established.

NECA recommended that this Advocacy Panel's role would be to allocate funding to specific projects. NECA recommended that the Advocacy Panel be constituted as follows:

- an independent chairperson appointed by NECA for three years;

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[174] See ACCC Determination on applications for authorisation, National Electricity Code, ACCC (22 December 1999).

- two representatives of end users; and
- two representatives of market participants.

NECA recommended that the Advocacy Panel report annually on its funding determinations, and that it be given $1m provisional funding for 2000-2001.[175]

In its Determination on amendments to the National Electricity Code of 19 September 2001, the Commission approved NECA's proposals.

The Commission acknowledges that there are some parallels between the case for end user advocacy funding in the NEM, and the case for analogous funding in the Victorian gas market.

As in the NEM, end users do not have a formal say in rule change procedures because they are not direct participants in the market. This is in contrast to supply side players such as producers, pipeline operators and retailers, who have voting rights on the GMCC as fee-paying participants.

Furthermore, as in the NEM, the interests of end users are disparate. For small end users, the individual gains from participating in end user advocacy processes are likely to be minimal. Accordingly, each end user is unlikely to contribute much time or money to end user advocacy issues.

In relation to the first factor, this is counterbalanced to some extent by VENCorp initiatives to include end users in decision making processes. End users are not excluded from VENCorp's formal consultation processes. Clause 8.3(b) of the MSOR provides that when a rule change is proposed, VENCorp:

> Must consult with persons who VENCorp considers will be likely to be affected by the proposed rule change…

VENCorp also provides a significant amount of publicly available information on its website. It also currently conducts significant consultation with end users. Furthermore, end users have been granted observer status at past GMCC meetings, and the Commission has recommended they obtain voting rights at future meetings in this *Final Determination*. These measures provide scope for end users to voice their concerns.

Furthermore, a seat on the GMCC already exists to represent market customers.

As mentioned in Energex' submission of 5 December 2002, there appear to be disparities in the views of various end users, at least some of whom, such as Visy, are capable of representing themselves.

A number of other factors militate against the call for end user advocacy funding in Victoria. Firstly, there is the size of the Victorian gas market, compared with the size of the NEM. Approximately $8 bn of electricity is traded through the NEM annually.[176] By contrast, the

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[175] See ACCC Determination on amendments to the National Electricity Code in relation to Inter-regional transfer of TuoS, treatment of losses, improvements to PASA, pricing under extreme conditions, demand side participation and end-user advocacy, 19 September 2001 p. 34.

[176] Australian Electricity Supply Development 2000 – 2002, Energy Supply Association of Australia, September 2002 at 3.

entire Victorian gas market has been valued at $1.4 bn.[177] However, gas traded on the spot market comprises only a small fraction of this. Approximately $35m was traded on the spot market during the 2001-02 financial year.[178] Given the disparity in size between the national electricity pool and the Victorian gas pool, end users in the Victorian gas market should have less difficulty making their views heard.

Additionally, end user funding in the NEM was granted principally to address issues such as NEC changes, which involve matter of policy. In gas, the analogous legal instrument is the Code; however funding derived from the Victorian gas market should only be used to address matters such as MSOR changes. The MSOR involve technical matters relating to the day to day operation of the PTS, rather than issues of policy. End user advocacy groups are likely to be better informed on such issues as a result of their involvement with the wholesale market. Therefore the issue of funding is less pressing. This also presents a substantial difference between the grant of funding in relation to the NEM, and the current request for funding in relation to the Victorian wholesale gas market.

Before end user advocacy for the Victorian gas market could be granted, it would be appropriate for VENCorp to conduct a review, in conjunction with participants and end users, to determine if a need for funding existed. If this need were found to exist, it would then be appropriate to establish an advocacy panel, similar to that created in the NEM, to oversee funding determinations. These exercises would be costly, both in comparison with the size of the Victorian gas market, and with the likely quantum of any subsequent funding. Such an exercise would be unlikely to generate benefits exceeding its cost. The Commission agrees with VENCorp's submission that the administrative arrangements necessary to ensure probity and good governance on the part of any end user advocacy panel could be costly.

Furthermore, any funding for end user advocacy would need to be levied from participants via an increase in market fees. This must be considered in the context of both the current size of the Victorian gas market, the current level of VENCorp's costs, and the current level of market fees. The imposition of additional fees would represent a distortion to the market. In a market as large as the NEM, this distortion is likely to be minimal. In the Victorian gas market, however, it could be more significant. Accordingly, the Commission considers that imposition of this levy would be unlikely to generate benefits relative to its costs.

Finally, the Commission does not accept EUAA's argument that energy users require funding to allow them to participate effectively in the GMCC process. The Commission considers that providing end users with a seat on the GMCC will allow them to raise issues that are important. However, the Commission reiterates that the benefits of providing funding to end users via a levy on all participants would be unlikely to generate benefits in excess of the costs of such a scheme.

Consequently, the Commission considers that the case for end user advocacy funding is not made out at this time.

6.2.7 Demand Management

Several interested parties have argued that the MSOR currently provide insufficient incentives for consumers of gas to adjust their usage in response to supply constraints or price fluctuations.

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[177] Estimate provided by VENCorp; relates to 2000.

[178] VENCorp Annual Report 2002 p. 5. See ww.vencorp.com.au.

Interested parties' submissions

EUAA submitted:

> In the absence of locational signals and constrained down ancillary payments, there are few incentives for the instigation of direct demand-side management initiatives in the wholesale gas market.[179]

EUAA argued that insufficiently volatile gas prices inhibit the potential for demand management. Notwithstanding, EUAA considered this is an important issue for the development of the Victorian gas market.[180]

EAG considered that gas consumers need to be able to understand and minimise their risk exposure. This might be achieved via hedging. EUAA also argued that the increased volatility from gas-fired generation is creating demand management issues.[181]

Issues arising since the Draft Determination

EUAA and EAG reiterated their comments at the predetermination conference.

VENCorp submits that this issue is dealt with primarily by the section dealing with the price mechanism currently operating on the PTS. VENCorp submits:

> The establishment of improved pricing signals are a pre-requisite for the facilitation of demand side management.[182]

Commission's considerations

The Commission agrees with EUAA and EAG that there currently appears to be minimal demand side response in the Victorian gas market. The events of 22 July 2002 demonstrate this, because gas consumers did not adjust their gas consumption in response to the constraint that occurred.

The Commission agrees with TXU that changes to the pricing mechanism on the PTS, which might include the introduction of locational hourly pricing, could potentially address this issue. Locational hourly price signals are likely to be more volatile, and accordingly more likely to elicit a demand side response. Furthermore, greater frequency of pricing signals should give gas consumers the opportunity to adjust their consumption in response to price fluctuations.

Beyond this measure, there may be other factors constraining the potential for demand side response. The contractual arrangements that exist between retailers and consumers might have this effect. It is a matter for retailers and consumers as to what extent the risks associated with price volatility and supply constraints are incorporated into retail contracts.

6.2.8 Differences in gas balancing regimes

Issues raised by interested parties

Several interested parties commented that there needs to be standardisation of gas balancing regimes across jurisdictions.

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179 EUAA submission 6 August 2002 p. 8.

180 EUAA submission 6 August 2002 p. 8.

181 EAG submission 19 August 2002 p. 6.

182 VENCorp submission 5 December 2002 p. 5, note 8.

EAG argued that different balancing arrangements across states inhibits the development of a national gas market.[183] EAG argued that possibly four or five different system balancing regimes could emerge in different states. EAG summarised its position with the following recommendation:

> EAG recommends that if it is at all possible, ACCC adopt a strategy to Authorise market arrangements that ensure that the various jurisdictional gas MSOR's converge to a single national market over 10 years.[184]

EUAA's submission of 6 August 2002 expressed similar sentiments. EUAA commented:

> The EUAA feels it is not in the best interests of gas users to have differing gas market designs across the states and that it is important to create conditions conducive to a national gas market. With all other states having opted for contract carriage, in the interests of promoting a single national gas market, it will be necessary at some stage to move further towards a national gas market concept that minimises impediments to interstate trade in gas. We feel that the ACCC needs to consider this factor in its reauthorisation of the MSOR.[185]

Issues arising since the Draft Determination

EUAA and EAG reiterated their comments at the predetermination conference.

VENCorp submits that this issue is beyond the power of either VENCorp or the ACCC. VENCorp notes that there is a wide range of contract carriage models in operation on pipelines around Australia, and that these are generally accompanied by private contractual arrangements that are generally confidential. VENCorp argues:

> It is not within the power of governments or the ACCC to unilaterally impose changes to the existing market or contracting arrangements on all pipelines.[186]

Commission's considerations

The Commission does not consider it appropriate to make recommendations in relation to the national consistency or otherwise of gas balancing regimes in the context of this application for authorisation. In relation to an application for authorisation, the Commission is required to assess whether there are anticompetitive detriments likely to result from the conduct proposed, and if so whether these are outweighed by any benefit to the public also likely to result from the proposed conduct.

The fact that there are different gas balancing regimes across States represents a public detriment resulting from the MSOR only to the extent that market carriage inhibits interstate trade. This issue is discussed in section 6.1.4 of this *Final Determination*.

Furthermore, it is clear from the Code that a pipeline service provider may opt for either a contract carriage or market carriage capacity management policy. Therefore it would be inappropriate for the Commission to mandate a single balancing system for all regulated pipelines. In any case this is would not be a matter for the current authorisation process.

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183 EAG submission 19 August 2002 p. 5.

184 EAG submission 19 August 2002 p. 6.

185 EUAA submission 6 August 2002 p. 11.

186 VENCorp submission 5 December 2002 p. 5.

6.2.9 Use of market information by participants

Applicant's submission

VENCorp submits that the benefits to the market of wide ranging disclosure of information continue to outweigh the potential for collusion among market participants. VENCorp notes that no evidence of coordinated behaviour by participants has arisen since market commencement.[187]

Interested parties' submissions

AGL argues that greater information disclosure by VENCorp should lead to more transparent markets.[188] Energex considers that contrary to encouraging anti-competitive behaviour, such disclosure would assist in identifying such behaviour.[189]

Commission's considerations

In its 1998 Determination the Commission indicated:

> … the Commission does have strong reservations regarding the release of information and the possibility that it may be used to manipulate spot price outcomes, principally due to the nature of the trading environment. Gas spot sales may be characterised in a similar manner to the NEM, that is, a repeated 'game' with few players. This may encourage anti-competitive behaviour by:
>
> – Disclosing bidding strategies that others may take advantage of; and/or
>
> – Facilitating tacit collusion between participants.[190]

While the potential for coordinated conduct remains, it appears not to have occurred since market commencement.

Against this should be weighed the benefits to the market flowing from increased information and greater transparency of pricing. Increased circulation of information allows all participants to scrutinise spot prices and market behaviour, and identify any suspect anti-competitive conduct. The Commission considers that the benefits of this transparency outweigh the potential detriment caused by the threat of coordinated behaviour.

However, as this threat persists, the Commission considers that VENCorp should continue its market monitoring obligations under clause 1.2.1.

6.2.10 Complexity of the MSOR

Applicant's submission

VENCorp argues that the complexity of the MSOR springs from *inter alia* the following factors:

- structural reforms to the Victorian gas industry;
- making risks more transparent;

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187 VENCorp submission 20 May 2002 p. 63.

188 AGL submission 28 June 2002 p. 3.

189 Energex submission 17 June 2002 p. 15.

190 ACCC 1998 Determination p. 127.

- providing information to users that reduces information asymmetry between existing users and new entrants; and
- the inherent underlying complexity of the PTS.[191]

VENCorp concludes that because the MSOR deal with complexity and risk in a transparent way, their complexity does not constitute a barrier to entry, as evidenced by entry of new players into the market since its inception.[192]

Interested parties' submissions

Esso argues that the complexity of the MSOR relative to gas trading arrangements in other States deters investment by users, pipeline owners and gas producers.[193]

Energex contends that, since no comprehensive alternative to market carriage has been put forward, there is no meaningful standard with which to compare the complexity of the MSOR. Energex proceeds to state that if contract carriage arrangements were developed in detail, they would entail almost as much complexity. Energex supports VENCorp's claim that the complexity of the MSOR results from the underlying physical constraints of the PTS.[194]

EUAA considers that the complexity of the MSOR requires end users to make substantial investments to operate directly in the market, which has the effect of discouraging end user participation. EUAA suggests that further simplifications of the MSOR take place, and that the Commission should require some simplifications as part of its authorisation process.[195]

Issues arising since the Draft Determination

At the predetermination conference, EUAA reiterated its view that the MSOR should be simplified.

Commission's considerations

In its 1998 Determination, the Commission concluded on this issue:

> Overall, the Commission recognises that due to the range of reforms it seeks to encompass the MSOR is a lengthy and complex document. However, the Commission considers that the benefits from explicit documentation of standards, technical requirements and the rights and obligations of participants promotes transparency and thus outweighs any anti-competitive detriment arising out of the complexity of the MSOR.[196]

By and large, the Commission continues to hold this view.

Under contract carriage, users generally undertake lengthy and complex negotiations with pipeline owners in order to secure contracts for the supply of gas. The contracts that shippers and pipeline owners subsequently enter can also be lengthy and complex. As with buying gas in Victoria, this process necessitates a significant investment in time and human resources.

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191 VENCorp submission 20 May 2002 pp. 66-70.

192 VENCorp submission 20 May 2002 p. 70.

193 Esso submission 19 July 2002 p. 3.

194 Energex submission 17 June 2002 p. 16.

195 EUAA submission 6 August 2002 p. 7.

196 ACCC 1998 Determination p. 47.

Furthermore, as Energex notes, any system of market operations in Victoria would need to deal with the complexity underlying Victoria's transmission constraints.

It should also be considered that the gas arrangements in Victoria are considerably less complicated than the arrangements relating to the NEM. All of Victoria's incumbent gas retailers are already electricity retailers, and they are required to familiarise themselves with the electricity arrangements relating to the NEM. Given this, the incremental cost of understanding the MSOR is likely to be minimal.

Overall, the Commission considers that the complexity of the MSOR does not go beyond what is necessary to achieve an efficient and competitive gas industry. In short the Commission considers that the benefits from explicit documentation of standards, technical requirements and the rights and obligations of participants promote transparency and outweigh any anticompetitive detriment arising out of the complexity of the MSOR.

The Commission does not accept EUAA's suggestion that the Commission should require specific simplifications to the MSOR. The Commission considers that this would be an inappropriate step for a competition authority, and that such matters are best left to VENCorp, which has the necessary technical expertise. Furthermore, any market participant could suggest changes to the MSOR through the GMCC process.

6.2.11 Single zone daily pricing

Currently, under clause 3.2.1, prices are determined daily, treating the PTS as a single zone. Prices are determined *ex post*, i.e. for the previous day. In their submissions, VENCorp and several interested parties discuss whether prices should be determined hourly and across multiple zones.

Applicant's submission

VENCorp acknowledges that the current model of single zone *ex post* daily pricing 'smears' the costs of managing within day events, rather than allocating costs to the cause of such events.[197] VENCorp also acknowledges that the need for uplift payments arises partly from the use of this simplified pricing model.[198]

VENCorp indicates that a review it conducted of market arrangements in early 2001 found insufficient justification to introduce locational and hourly pricing.[199] The review found that although adequate metering[200] and software[201] exist to accommodate locational hourly pricing, the change was not justified given:

- the significant costs involved;[202]
- other measures could address the relevant issues in the short term at lower cost; and
- the absence of a pressing need to introduce locational hourly pricing.[203]

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197 VENCorp submission 20 May 2002 p. 54.

198 VENCorp submission 20 May 2002 p. 52.

199 VENCorp submission 20 May 2002 p. 53.

200 Review of Victorian Gas Market Arrangements 15 March 2001 p. 29. See www.vencorp.com.au.

201 Review of Victorian Gas Market Arrangements 15 March 2001 p. 28.

202 Review of Victorian Gas Market Arrangements 15 March 2001 pp. 39-40.

Interested parties' submissions

TXU has made substantial comments advocating a move to locational hourly pricing. TXU cites three factors that necessitate this move.

Single zone daily pricing requires uplift charges to balance the system. While these uplift charges have been small to date, the risk of uplift remains and cannot be hedged against. Future development of Victoria's gas and electricity markets will exacerbate the situation.

Gas-fired electricity generation is becoming increasing prevalent in Victoria. Because electricity generators respond to real-time fluctuations in electricity prices, they need more accurate gas price information.

Locational hourly pricing will reflect constraints at peak times and locations, and will therefore encourage investment for peak times and locations.[204]

TXU also argues that since the issue has already been the subject of several reviews by VENCorp, another would not be productive. Accordingly, TXU recommends that the Commission require as a condition of authorisation that VENCorp introduce locational hourly pricing.[205]

TXU made a further submission to the Commission on 5 September 2002. In this submission TXU argues that the market failed on 22 July 2002, and that curtailment would not have been necessary if locational hourly pricing had been in place. TXU makes the following points:

- the price rose insufficiently to induce a demand side response;
- the *ex post* price for 22 July 2002 of $9.20 did not rationally reflect supply constraints on the day;
- the *ex post* price sent inaccurate investment signals; and
- the ancillary payments of $164,000 did not reflect the true cost of the events of 22 July 2002 to consumers.[206]

TXU argues that demand side response did not occur on 22 July 2002 because there is currently no provision in the MSOR for re-bidding within a day. This was unfortunate, TXU reasons, because gas-fired generators are well placed to offer a demand side response, on account of their relative flexibility and access (in some cases) to auxiliary fuel.[207]

TXU argues that under a locational hourly pricing regime, the spot price would have risen to VoLL at some locations, and no ancillary payments would have been necessary.[208]

TXU contends that an hourly locational pricing regime would send accurate price signals to efficient investment, including investment in the following categories:

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203 Review of Victorian Gas Market Arrangements 15 March 2001 p. 42.

204 TXU submission 17 July 2002 pp. 5-7.

205 TXU submission 17 July 2002 p. 7.

206 TXU submission 5 September 2002 pp. 3-5.

207 TXU submission 5 September 2002 pp. 5-6.

208 TXU submission 5 September 2002 p. 7.

- supply systems;
- peak supply; and
- expanded pipeline capacity, where appropriate.

TXU also considers that locational hourly pricing might encourage uncontracted gas to enter the PTS.[209]

Furthermore, TXU advances the view that locational hourly pricing would encourage a demand side response by:

- encouraging users to voluntarily reduce their gas usage when prices reach high levels; and
- encouraging demand side loads to bid into the market.[210]

TXU argues that it would take two years to design, gain approval for and introduce locational hourly pricing. Accordingly, TXU submits that the Commission should require as a condition of authorisation that locational hourly pricing be introduced.[211]

EAG submits that moving to locational hourly pricing would 'sharpen up' prices. EAG considers that users need to be able to understand and manage their risks of exposure to high prices. EAG submits that this is prevented by the current cost smearing arrangements.[212]

EAG also argues:

> The complexity of the MSOR provided a lack of incentive and market signals to develop any demand side responses.[213]

EUAA also makes the following comments on the potential for demand side response:

> In the absence of locational signals and constrained-down ancillary payments, there are few incentives for the instigation of direct demand side management initiatives in the wholesale gas market.[214]

Energex considers that single zone daily pricing is acceptable at present, given the cost and complexity that would be involved in moving to locational hourly pricing.[215]

In its submission of 5 September 2002, Energex disputes a number of TXU's claims.

Firstly, Energex argues that $9.20 GJ represents the true value of gas on 22 July 2002. Energex argues that the daily price and the quantum of ancillary payments for this date do not constitute *prima facie* evidence of a flawed market design.[216]

Furthermore, Energex claims that it is incorrect to say that the current market price sends inadequate investment signals. Energex argues that infrastructure development such as Vic

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209 TXU submission 5 September 2002 p. 7.

210 TXU submission 5 September 2002 p. 7.

211 TXU submission 5 September 2002 pp. 9-12.

212 EAG submission 19 August 2002 p. 4.

213 EAG submission 19 August 2002 p. 4.

214 EUAA submission 6 August 2002 p. 8.

215 Energex submission 17 June 2002 p. 12.

216 Energex submission 5 September 2002 pp. 1-2.

Hub and gas-fired generation, as well as development of new gas fields in the Otway basin, attest to the contrary.[217]

Energex states:

> Rather, ENERGEX believes that the matter, which should be the focus of the ACCC in considering Texas Utility's supplementary submission is – what process best enables the Victorian gas industry (being a collective body of end use customers, and interested and in some cases competing commercial businesses) to decide which market model to adopt in the coming years.[218]

Energex considers that the best process is provided by VENCorp's consultative forums.[219]

Applicant's response

VENCorp acknowledges that single zone/daily pricing is unlikely to meet the evolving needs of the market. However, for locational hourly pricing to be introduced, complex design issues must be considered. VENCorp argues that this change should proceed through the rule change process, with full consultation with all interested parties, but that consensus does not exist on the immediate need for this change.[220]

Issues arising since the Draft Determination

TXU submits that if VENCorp does not commence its review into the current pricing arrangements before 30 June 2003, the review is unlikely to be completed before early 2004, and its recommendations might not be implemented before early 2006. TXU submits this would be too late, given that developments such as VicHub and the construction of the SeaGas pipeline may well occur by January 2004. TXU submits the review into the current pricing arrangements should commence by 1 March 2003.[221]

TXU also submits that VENCorp's review should take account of overall efficiency arguments, and should identify how timely investment would occur in the absence of a more robust market model.[222]

Commission's considerations

In addition to reviewing the submissions from interested parties on this issue, the Commission also conducted meetings with the following interested parties to canvas their views on the possible introduction of locational hourly pricing:

- TXU;
- Energex;
- AGL;
- EUAA;
- EAG;

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217 Energex submission 5 September 2002 p. 2.

218 Energex submission 5 September 2002 p. 2.

219 Energex submission 5 September 2002 p. 3.

220 VENCorp submission 19 August 2002 pp. 10-11.

221 TXU submission 5 December 2002 p. 5.

222 TXU submission 5 December 2002 p. 6.

- Duke Energy; and
- VENCorp.

At the inception of market carriage in Victoria, VENCorp was required by clauses 3.2.5 and 9.1.1 of the MSOR to review the issue of whether locational hourly pricing should be introduced. Having completed the necessary reviews, VENCorp submitted changes to the MSOR deleting these clauses. The Commission agreed to these changes, and the clauses have now been removed from the MSOR. Accordingly, VENCorp is no longer obliged to review the matter further.

The Commission considers that several benefits are likely to flow from the introduction of locational hourly pricing, or some other pricing modality capable of reflecting within-day constraints on the PTS.

A locational hourly pricing regime should ensure that the price of gas reflects its value at different times of the day, and at different locations. This would necessitate adjustments to the current mechanisms for managing system constraints and allocating transmission rights.

At present, AMDQ and AMDQ credit provide transmission rights. The holders of these instruments receive some protection from uplift payments (although not from surprise uplift), and from curtailment.

Uplift payments are required to compensate market participants for injecting additional gas into the PTS. Market participants who inject gas (generally LNG) in response to a transmission constraint are compensated at their bid price through ancillary payments, which are then recovered from other market participants through uplift payments. Some portion of this uplift (known as 'congestion uplift') is recovered from market participants who caused the constraint by exceeding their AMDQ or AMDQ credit entitlements. The remainder is recovered from all market participants as 'surprise uplift' on the basis of their total usage.

The bulk of uplift to date has been surprise uplift.[223] The Commission considers that surprise uplift is a sub-optimal method of compensating for within-day constraints, as it 'socialises' the costs of constraints across all users, rather than allocating costs to those who cause them.

Under a system of locational hourly pricing, the need for uplift payments would be largely eliminated. As a within day constraint arose, the price of gas at the relevant time and location would rise. As the price rose, various market participants might continue to purchase gas, depending on what valuation they placed on it. If provisions for rebidding gas within a day existed, market participants could bid further gas into the market in response to higher prices. The increased cost of gas attributable to the constraint would be borne by gas users at the time they purchase the gas.

This method of valuing gas at times of constraint is preferable to recovering the costs of ancillary payments through either congestion or surprise uplift payments. It is superior to the latter because the price increases are borne by those who value gas highly. It is also superior to the former because some gas users who would have been penalised through congestion uplift might have reduced their consumption of gas, had they known its cost reflective price.

It follows from this that locational hourly pricing is more likely to elicit a demand side response in times of constraint. If market participants receive hourly and locational price

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[223] Review of Victorian Gas Market Arrangements (2001) p. 12.

signals, they should be able to modify their demand profile accordingly. For example, if high prices at a particular time of day on the PTS were not matched by high prices in the NEM, gas-fired generators (particularly those with dual fuel capability) might voluntarily reduce or curtail their gas usage. As the retail market develops following the introduction of full retail contestability, domestic customers may be willing to enter more sophisticated arrangements to acquire gas. Such arrangements might provide domestic users with the incentive to reduce or curtail their usage during periods of constraint. This would lead to the potential for demand side response from domestic customers.

A third likely benefit from locational hourly pricing is that it should provide the price signals for efficient investment. The theory behind this is straightforward: the prices should reflect the valuation of gas at different times and places. High prices should provide different classes of market participants with the incentive to augment the PTS, either to:

- take advantage of the higher prices; or
- shield themselves from the high prices.

Since the price should accurately reflect the value of gas at a particular location, this investment should be efficient, that is it should occur where it is most valued.

In practical terms it is unclear what investment would actually occur in response to high prices during periods of constraint. TXU submitted that the following species of investment might occur:

- investment in supply systems to maintain maximum reliability during peak demand conditions;
- investment in supply systems to achieve short-term 'overload' capacity during peak demand conditions as has occurred in the NEM;
- long-term incentives for peak supply near load centres; and
- incentives to invest in expanding pipeline capacity where appropriate.[224]

The Commission accepts that locational hourly pricing should provide the pricing signals for at least some of this investment to occur, as warranted. The Commission also believes that it needs to be clarified not only what investment would occur if another pricing model were to be introduced, but also the investment that would occur if it were not.

A further benefit likely to flow from the introduction of locational hourly pricing would be that parties who were required to curtail their consumption at peak periods, and whose gas was redirected to other users, would be adequately compensated for this.

It is clear from this analysis that under a locational hourly pricing regime, concepts such as ancillary and uplift payments might become superfluous, or at least the need for them would be considerably lessened. Accordingly, any proposal to move to locational hourly pricing would require consideration of how these concepts should be adjusted.

Furthermore, as one of the principle reasons for holding AMDQ and AMDQ Credit is to protect against uplift payments, these instruments would also need to be reassessed.

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[224] TXU submission 5 September 2002 p. 8.

Therefore the Commission considers that benefits are likely to flow from the introduction of locational hourly pricing.

However, the Commission notes that there will also be costs associated with its introduction. Furthermore, other matters, including technical issues, will need to be resolved before its introduction. Accordingly, the Commission agrees with Energex' view that VENCorp's consultative processes provide the best means of progress on this issue.

To weigh the likely costs against the likely benefits, the Commission recommends that VENCorp undertake another review into whether another pricing mechanism should be introduced for the PTS. As part of this review, VENCorp should consider whether a locational hourly pricing mechanism, such as hourly nodal pricing, should be introduced.

This cost benefit analysis should attempt to capture all the relevant short and long term costs and benefits associated with the move to locational hourly pricing, including those of an economic nature.

The Commission considers that since VENCorp conducted a review into locational hourly pricing in 1999, several factors have arisen that warrant its re-examination:

- the increasing uptake of gas fired generation;
- the prospect of Otway basin gas entering the PTS; and
- the imminent introduction of full retail contestability.

The review conducted by VENCorp would also need to consider the following related issues:

- whether rebidding within a day should be permitted;
- whether the MSOR should provide for the injection of interruptible gas;
- whether the current pricing arrangements are likely to attract sufficient timely investment, and what investment might occur under alternative pricing arrangements;
- whether the current arrangements in relation to AMDQ and AMDQ Credit need to be adjusted; and
- whether the current arrangements in relation to ancillary payments and uplift payments would still be necessary, and if so what adjustments would be needed.

The Commission concurs with TXU's view that it would probably take two years to evaluate and test any new proposals. The Commission also agrees with TXU that it would be advantageous to commence this review as soon as possible. Accordingly, the Commission considers that VENCorp should commence this review before 1 March 2003.

The Commission considers that the introduction of another pricing mechanism may alleviate EAG's concerns of 'cost smearing'. The Commission also considers that the extent to which energy users are able to understand their risks and take steps accordingly is principally an issue for users and their representatives to address.

The Commission considers that the lack of demand side response at this time is not largely attributable to the complexity of the MSOR. On the contrary, the transparency with regard to

risks provided by the MSOR is likely to assist consumers in developing a demand side response supply and demand conditions on the PTS.

6.2.12 VENCorp's costs

The fees that VENCorp recovers from market participants are set out in clause 2.6 of the MSOR, and in the Victorian Gas Industry Tariff Order.[225] These include:

- a registration fee payable by each market participant under clause 2.6(c)(1);
- metering fees;
- commodity charges; and
- a system security gas storage charge payable by each market participant under clause 2.6(c)(10).

Applicant's submission

VENCorp submits that its costs are:

- 3-5 cents per Gigajoule for retailers and large customers;
- 1-2 per cent of the delivered price of gas for most users and customers; and
- 15 per cent of the total transportation tariff for shipping gas on the PTS.[226]

VENCorp submits that it is highly unlikely that an alternative model of systems operation could perform all of VENCorp's functions for less than 3-5 cents per Gigajoule.[227]

VENCorp concludes that its costs are 'prudent, reasonable and efficient and justifiable', relative to the services it provides and the benefits resulting from market carriage.[228]

Interested parties' submissions

EUAA submits that there are insufficient commercial pressures on VENCorp to minimise its costs. EUAA considers that VENCorp needs more incentives and penalties in order to benchmark its performance more effectively.[229]

Likewise, Energex submits that 'there should be prudent drivers on VENCorp to ensure that their costs are efficient in delivering true value to the end consumer.[230]

Issues arising since the Draft Determination

In its submission of 5 December 2002, VENCorp submitted that minimisation of its costs is currently achieved through the MSOR, VENCorp's governance arrangements, and the access arrangement process.[231]

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225 Made under section 48A of the *Gas Industry (Residual Provisions) Act* 1994.

226 VENCorp submission 20 May 2002 p. 64.

227 VENCorp submission 20 May 2002 p. 66.

228 VENCorp submission 20 May 2002 p. 66.

229 EUAA submission 6 August 2002 p. 7.

230 Energex submission 17 June 2002 p. 16.

Commission's considerations

Currently, VENCorp's actions, and its costs, are subject to scrutiny in a variety of forms. These include:

- VENCorp's corporate behaviour and financial statements are audited by the Victorian Auditor-General's office;
- VENCorp's corporate plan is subject to approval by Victorian State Treasury;
- VENCorp is required to submit an access arrangement to the Commission for assessment under the Code, in respect of its charges; and
- VENCorp's annual budget is reviewed by the Commission.[232]

In its *Draft Decision* on VENCorp's access arrangement, the Commission considered whether VENCorp should be benchmarked against other similar agencies, such as the National Electricity Market Management Company Ltd (NEMMCo). The Commission highlighted that such an exercise would need to generate cost savings in excess of the costs of benchmarking itself. Given this, the Commission considered that benchmarking would be too costly. Accordingly, the Commission concluded that VENCorp's internal benchmarking, and its internal KPIs, are sufficient to ensure that VENCorp operates efficiently.[233]

VENCorp's revenues are regulated under the Code. In evaluating VENCorp's proposed charges under s. 8.1(a) of the Code, the Commission considered:

> VENCorp operates on a cost recovery basis, making no allowance for profit. The Commission considers that the high degree of transparency required with respect to VENCorp's operations mitigates inefficient costs. Following analysis of VENCorp's tariff modelling, the Commission considers that VENCorp's proposal provides it with the opportunity to recover efficient costs associated with providing its services. As such, the Commission considers that VENCorp's proposal complies with section 8.1 (a) of the Code. The Commission will continue to review VENCorp's annual budgets and reference tariffs and encourage greater efficiency wherever possible.[234]

Accordingly, the Commission considers that VENCorp's costs are reasonable given the functions it performs. No comprehensive analysis has been done that suggests the functions of pipeline operator could be performed in Victoria at a substantially lower cost, even via contract carriage.[235]

6.2.13 Allocation of quantities at multiple injection points

Clause 3.5.2 of the MSOR requires that if more than one market participant uses a system injection point, the market participants using that point must allocate a single allocation agent.

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231 VENCorp submission 5 December 2002 p. 5.

232 VENCorp submission 20 May 2002 p. 61.

233 ACCC *Draft Decision* on access arrangement submitted by VENCorp on 14 August 2002 (ACCC VENCorp Draft Decision) p. 41.

234 ACCC VENCorp Draft Decision p. 16.

235 Some analysis into this question is provided by a report entitled "Review of the Victorian Gas Market", produced by the Allen Consulting Group in March 2001. This report contains estimates of the costs of operating a contract carriage system in Victoria. However, its analysis is not comprehensive. Furthermore, its findings do not reveal a substantial cost differential between the current and proposed system. As Energex points out, it contains no estimates of the costs associated with the transition to contract carriage. Finally, no estimates are provided of whether contract carriage could be provided more efficiently.

This allocation agent informs VENCorp how much gas has been injected by each market participant at that injection point. It is clear from clause 3.5.2(c) that only one allocation agent may be appointed for each injection point.

There is currently an allocation agreement in force at the Longford injection point called the Longford Allocation Master Agreement (LAMA). Trowbridge Consulting is the appointed allocation agent.

Interested parties' submissions

Visy submits that they should not be required to join the LAMA. Visy claims that the LAMA is potentially anticompetitive, particularly because LAMA fees are split equally between participants, rather than proportionate to gas injection volumes. Visy also argues that because their agreement to purchase gas is with Esso/BHP rather than with Gascor, joining the LAMA does not provide them with any benefit.[236]

Applicant's response

In response to Visy's submission, VENCorp makes the following points:

- Visy's complaint is mainly with the LAMA rather than the MSOR per se;
- the systems operator is able to meter the total amount at each injection point, but not the allocated amounts;
- accordingly, someone is required at a multiple injection point to define whose gas is being delivered for balancing and billing purposes;
- amounts at multiple allocation points must be defined in accordance with contracts;
- industry has been adamant that VENCorp should not be involved in these contracts; accordingly, an authoritative party is required at the injection point;
- the allocation agent must be able to enforce decisions at the injection point; and
- the MSOR provides for sub allocations, which allow additional flexibility.[237]

Commission's considerations

Generally, under a system of contract carriage, a gas shipper is required to provide the pipeline operator with written confirmation of its contract with the gas producer.[238] This written confirmation forms the basis for nominated quantities at each injection point. If there are multiple parties at a single injection point, metered injections are allocated between shippers in accordance with their nominated quantities.

Under the MSOR, market participants are not required to provide similar confirmation to VENCorp. This is to ensure that VENCorp does not become involved with contracts between producers and market participants. The Commission accepts VENCorp's assertion that market participants would prefer VENCorp not to have access to these contracts.

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[236] Visy submission 23 July 2002 p. 1.

[237] VENCorp submission 19 August 2002 p. 22.

[238] See, for example, ACCC access arrangement for the Moomba to Adelaide Pipeline System (MAPS) clause 18.2.

Accordingly, there must be a nominated agent at each receipt point, who is privy to contracts for gas supply, and who can state authoritatively the allocation of gas between multiple shippers. The requirement for the appointment of such an agent has the potential to raise issues under section 47 of the TPA. However, the Commission accepts VENCorp's comments that market participants would prefer that VENCorp not have access to their gas supply contracts.

The Commission notes that Visy's concerns could be alleviated if it could reach agreement with Esso/BHP and VENCorp under which Esso/BHP would indicate to VENCorp how much gas it had injected on Visy's behalf. A sub-allocation agent could then indicate to VENCorp the allocations at Longford for all the other parties. The Commission is neither empowered nor inclined to require such an agreement. It merely notes that such an agreement is possible.

More generally, the Commission does not consider that public detriment from a lessening of competition results from clause 5.3.2 of the MSOR. For the reasons outlined above, the Commission considers that the appointment of allocation agents is necessary.

6.2.14 Other potential detriment raised by interested parties

Interested parties' submissions

Esso submits that dispatch is based on the bids of market participants, rather than firm contractual commitments. Esso argues that in theory, if a market participant bid into the pool at zero, this might not ensure dispatch if other market participants also bid in at zero. This is because the bids would be prorated among all market participants bidding in at zero. Furthermore, if a shortfall in demand occurred, all market participants who bid in at the same price would have their injection quantities reduced, even where the reduction in demand was caused by an unrelated end user.[239]

Esso also argues that there may be circumstances where VENCorp, through error such as a weather forecasting error, may limit the supply of lower priced gas. It may then be required to call on higher priced gas, which may then result in uplift charges.[240]

Commission's considerations

The Commission agrees that where several participants bid into the pool at zero, they may have their bids prorated. However, this possibility seems remote. A zero bid would fall at the bottom of the bid stack, and unless demand for gas on a day were extremely low, the zero be likely to be called on in full.

This is, of course, different to contract carriage, where contractual commitments would ensure throughput. However, this mechanism does appear to schedule bids in an efficient manner to reflect the amount of gas demanded on a day.

In relation to Esso's concern that market producers may be forced to inject lower quantities as a result of a shortfall in demand, the Commission considers that although this risk does exist in relation to gas traded on the spot market, it is concomitant to the efficient clearing mechanism provided by spot trading. The Commission has outlined its views on the benefits of the spot market in section 5.1.4 of this *Final Determination*.

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[239] Esso submission 19 July 2002 p. 4.

[240] Esso submission 19 July 2002 p. 4.

In relation to Esso's concerns that lower priced gas might be constrained, the Commission reiterates its view that total uplift payments have been relatively low to this point. Furthermore, it is reasonable to anticipate some degree of forecast error from the systems operator under any system.

As a further point, this concern of Esso's would be alleviated if the MSOR were amended to provide for interruptible gas to enter the pool. The Commission has recommended VENCorp consider this option should it conduct a review into the possible introduction of locational hourly pricing.

7. Period of Authorisation

Section 91(1) of the TPA provides:

> 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 applicant has sought authorisation for a period of ten years, from 1 January 2003 to 31 December 2012.

Applicant's submission

VENCorp contends that a ten year period of authorisation is appropriate given that it would provide certainty in the gas industry, avoid unnecessary market disruption and significant regulatory costs.[241] VENCorp contends further that the MSOR include procedures for implementing changes which involve industry consultation and require Commission approval if the MSOR are amended.[242]

Section 205 of the Gas Industry Act provides that a statutory review of Part 8 of that Act must be undertaken in 2007 and completed on or before 31 December 2007. That review will examine the current role of and functions of VENCorp with particular regard to the competitiveness of markets for and in relation to gas. VENCorp submits that a ten year period of authorisation would avoid the practical and resourcing tensions that would result if an authorisation application were being considered at the same time as the statutory review. VENCorp notes that the two reviews would be very different and possibly conflicting.[243]

VENCorp also points out it is not uncommon for the Commission to grant authorisation for lengthy periods and in the electricity industry the transmission network revenue cap decisions are not aligned with authorisation applications.[244]

Interested parties' submissions

AGL, TXU, Visy, Energex and the DNRE submit that a ten year authorisation is appropriate. In contrast, Esso, GasNet, EUAA and EAG suggest that the authorisation, if granted, should be for a considerably shorter period.

Esso submitted that if the Commission authorises the MSOR, it should do so for significantly less than ten years because the effectiveness of the MSOR has not been fully tested. The introduction of full retail contestability, the introduction of new sources of gas and the cessation of the historic base load gas supply arrangements are all events that will test the effectiveness of the MSOR and therefore the MSOR should be reconsidered after those changes take place.[245]

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241 VENCorp submission 20 May 2002 p. 8.

242 VENCorp submission 20 May 2002 p. 8.

243 VENCorp submission 20 May 2002 p. 8.

244 VENCorp submission 20 May 2002 pp. 7-9.

245 Esso submission 19 July 2002 p. 2.

GasNet contends that any authorisation granted should not exceed a period of five years for the following reasons:[246]

- a five period is consistent with the period contained in the proposed access arrangements lodged by GasNet and VENCorp and there is merit in aligning the duration of the authorisation and access arrangements because there is uncertainty regarding the terms and conditions of future access arrangements;
- the authorisation period should coincide with the statutory review planned; and
- there are a number of market developments which will occur in the next five to ten years and a ten year authorisation period would not provide sufficient flexibility to address those developments.

GasNet also noted that the service envelope agreement, which sets out the basis on which GasNet makes the gas transmission available to VENCorp, expires in December 2007. GasNet submitted that any authorisation granted should not extend beyond December 2007 because there is no certainty regarding the availability of the gas transmission system from GasNet after the expiry of the current service envelope agreement. An authorisation beyond 2007 might give rise to the implication that the service envelope agreement should continue in its current form.[247]

EUAA contends that the MSOR should be authorised for only five years for the following reasons:[248]

- end users remain uncertain about the MSOR;
- there have been very few instances of the PTS being constrained since the MSOR came into operation, and therefore it is untested under pressure; and
- a five year period would align the authorisation period with the operation of the proposed access arrangements for the PTS lodged by VENCorp and GasNet, and the statutory review.

The DNRE contends that a ten year period of authorisation would avoid conflicts with the statutory review. The DNRE notes that clause 5.3.1 of the MSOR requires that VENCorp and the transmission pipeline owner must enter into a service envelope agreement, and that there must be a valid agreement in place at all times. Clause 5.3.1 is a legal obligation with which GasNet must comply, and represents Government policy as it is necessary for the establishment and ongoing role of an independent systems operator.[249]

Visy, TXU, Energex and AGL all submit that a ten-year authorisation period would promote stability and certainty in the industry. In this context, AGL argues that this would encourage investment and new entry.[250] Energex indicated that certainty is particularly relevant where retailers still predominantly enter into long term contracts with gas producers.[251] Visy

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246 GasNet submission 11 July 2002 pp. 2-3.

247 GasNet submission 11 July 2002 pp. 2-3.

248 EUAA submission July 2002, p. 6.

249 DNRE submission 14 August 2002 p. 4.

250 AGL submission 28 July 2002, pp. 1-2.

251 Energex submission 17 June 2002 p. 5.

contends that the rule change process within the MSOR is sufficient to address necessary amendments to the MSOR within the authorisation period.[252]

AGL also submits that there is merit in reviewing the MSOR after the expiry of the Longford gas supply contracts, as experience of the effectiveness of the MSOR in the absence of those contracts could be taken into account in the next review.[253]

Applicant's Response

In response to submissions from interested parties, VENCorp submits that there is no legal or practical requirement to link the reviews of access arrangements or competition authorisations.

VENCorp also notes that section 160(1)(c) of the Gas Industry Act requires that VENCorp act as independent systems operator of the PTS, and accordingly GasNet's obligations to make the PTS available to VENCorp do not cease in December 2007.

Issues arising since the Draft Determination

In the predetermination conference, EAG argued that the MSOR are still developing and the Gascor contracts expire in 2007-2008, and as such the proposal in the *Draft Determination* to authorise the MSOR for ten years is questionable. EUAA made similar comments, suggesting that the MSOR are immature and not fully tested, and as such authorisation should not be granted for ten years.

Both EAG and EUAA have submitted that the authorisation, if granted, should expire 12 months after the legislative review of VENCorp and its functions.

At the predetermination conference IPA argued that the Commission should not 'lock in' the MSOR for a long period of time because to do so would perpetuate inefficiency.

At the predetermination conference, and in its subsequent submission, Energex submitted that the proposal to authorise the MSOR for ten years should be maintained. In its submission, Energex claims that it is important that an authorisation process does not impede the statutory review.[254]

Energex submits further that as retailers bear the greatest risk in the gas industry, and retailers take a long term position when contracting with gas producers, the period of authorisation should be consistent with the long-term contracts entered into. A ten year period of authorisation is required to ensure a stable regulatory environment consistent with the risk undertaken by retailers.[255]

In respect of the Gascor contracts expiring in 2007-2008, Energex indicated at the predetermination conference that retailers will negotiate new contracts well in advance of the current contracts expiring and therefore this is not a valid justification for a shorter period of authorisation.

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252 Visy submission 23 July 2002 p. 2.

253 AGL submission 28 July 2002 pp. 1-2

254 Energex submission 5 December 2002 p. 2.

255 Energex submission 5 December 2002 p. 2.

TXU also support a ten year period of authorisation. TXU submit that there are sufficient mechanisms for the MSOR to be reviewed and revised within this period if necessary. TXU cites the rule change process, the statutory review and revocation of authorisation due to material changes in circumstances, as examples.[256]

According to TXU, a ten year authorisation provides certainty and minimises the costs and distractions of an additional regulatory review. TXU notes that:

> If the statutory review identifies the need for changes to the market design, then it is entirely possible that the 2010 authorisation will need to be conducted while the changes identified from the statutory review are being designed/implemented. Once the changes have been completed, it is likely a further authorisation would be required again anyway! [257]

At the predetermination conference VENCorp made a number of comments in relation to the period of authorisation, which it subsequently reiterated in its submission of 5 December 2002. In particular, VENCorp submits that the rationale for granting a ten year authorisation remains sounds as it avoids the costs and risks associated with market uncertainty, and minimises overlapping, potentially conflicting processes. VENCorp emphasises that it is not seeking to avoid industry, regulatory or statutory review and notes that there will be a number of reviews of VENCorp throughout the ten year period. VENCorp also notes that if fundamental changes are required by the statutory review, these may take up to two to three years to implement. If this is the case, a mandated reauthorisation process could be unnecessary and impede the implementation of these changes.[258]

Commission's considerations

In the *Draft Determination*, the Commission proposed to authorise the MSOR for ten years. The Commission has reassessed this proposal in light of subsequent submissions.

Regulatory and statutory reviews

In advocating a shorter authorisation period, several applicants highlighted the forthcoming statutory review and the expiry of access arrangements as reasons to limit the period of authorisation.

The statutory review could result in substantial changes to VENCorp and the MSOR. If authorisation were granted for a period of five years, the subsequent authorisation application would need to be assessed during 2007. Such an assessment could be redundant given significant changes could subsequently be implemented and would possibly need to be authorised.

Section 91B of the TPA provides for a person to whom an authorisation is granted to apply for a revocation of that authorisation. Section 91B also provides for the Commission to revoke authorisation if there is a material change in circumstances. Therefore, if the statutory review resulted in significant changes to the MSOR the Commission could revoke its authorisation. The applicant would then need to make a fresh application for authorisation.

Given that the review must take place in 2007, a five-year authorisation is not appropriate. If material changes occur after the review, the current authorisation can be revoked under section 91B of the TPA.

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256 TXU submission 5 December 2002 p 2.

257 TXU submission 5 December 2002 p 2.

258 VENCorp submission 5 December 2002 p 2-4.

EAG and EUAA suggest that the authorisation should expire one year after the statutory review is completed. However, the Commission is concerned that by limiting the period of authorisation in this way, a reauthorisation application may be submitted while any changes required are being implemented, which could be an impediment to the implementation.

While the access arrangements for the PTS and the authorisation are related, there is no reason why they must be assessed at the same time. They are conducted under different legislation, namely the TPA and the Code, and while there is some overlap in the subject matter of the access arrangements and the MSOR, an authorisation and access arrangement are assessed under distinct criteria.

VENCorp must fulfil its functions as systems operator of the PTS in accordance with the MSOR. The terms and conditions of VENCorp's access arrangement are therefore based in part on the requirements of the MSOR. It is possible that as part of the assessment of a proposed access arrangement, an amendment to that access arrangement could be required which would result in the need to change the MSOR. However, this could be effected through the rule change process.

The MSOR impacts on GasNet to the extent that it requires a service envelope agreement between it and VENCorp, but does not effect the terms and conditions of an access arrangement proposed by GasNet.

Thus, there is no reason why authorisation applications and the PTS access arrangements need to be reviewed at the same time.

Industry developments

A number of developments are expected to occur in the Victorian gas industry in the near future, such as the injection of gas from new sources and the expiration of the Gascor contracts. As argued by some interested parties, the ability of the MSOR to accommodate these developments remains unproven. However, given that market carriage provides more flexibility than contract carriage, it appears likely that the MSOR would be able to deal with multiple injection points and full retail contestability. Indeed, the MSOR was designed to accommodate such developments.

Nevertheless, if this is not the case, the MSOR can be reviewed at that time. If the MSOR proves ineffective, this may constitute a material change in circumstances warranting revocation of the authorisation under section 91B of the TPA. Alternatively, where minor amendments are required, these could be implemented through the rule change process in the MSOR and submitted to the Commission as applications for minor variation.

There have been 15 rule changes since the MSOR was introduced and the Commission considers the rule change mechanism to be effective.

In regard to the expiration of the Gascor contracts, the Commission notes that, as submitted by Energex, in the gas industry contracts are typically renegotiated well in advance of their expiration.

Expiration of the service envelope agreement

GasNet's submission that there may not be a service envelope agreement after 2007 does not appear to be sustainable. Clause 5.3.1 of the MSOR requires that a service envelope agreement be in place at all times. Section 169(1)(c) of the Gas Industry Act provides for VENCorp to act as independent systems operator of the PTS, which implicitly requires that a

service envelope agreement be in place. As noted by the DNRE, the existence of an independent systems operator is Victorian Government policy and is mandated in legislation. Subject to competition concerns raised by the Commission, it appears that the owner of the PTS must negotiate a new service envelope agreement after the current agreement expires. As such the Commission does not consider that the expiration of the service envelope agreement in 2007 necessitates an authorisation period of less than ten years.

Conclusion

The Commission notes that many parties, in advocating a shorter period of review, have focussed on the need for additional objective review of VENCorp and the MSOR. It must be noted that an authorisation application relates to whether the public benefits of particular conduct outweigh any anticompetitive detriments. The Commission does not consider that the competition issues relevant to an authorisation application require a shorter authorisation period. The Commission is aware that industry developments and changes to the MSOR may occur throughout that period which may require authorisation to be revoked. It is not clear when or if those developments will occur, and therefore authorising for a shorter period would not be beneficial.

The Commission believes that authorisation of the MSOR should be for ten years. The Commission therefore requires the following condition:

C7.1 Authorisation of the MSOR is granted until 31 December 2012.

8. Assessment of net public benefits and detriments

As outlined in section 3 of this *Final Determination*, VENCorp has applied for authorisation of the MSOR under sections 88(1) and 88(8) of the *Trade Practices Act*.

The Commission must not grant an authorisation:

- Under s. 88(1) (excluding an exclusionary provision) or s. 88(8) (excluding conduct to which s. 47(6) or s. 47(7) applies) unless it is satisfied in all the circumstances that:
  - the provisions or conduct would result (or be likely to result) in a benefit to the public; and
  - that benefit would outweigh the detriment to the public constituted by any lessening of competition that would result (or be likely to result) from the proposed contract, arrangement, understanding or conduct (s. 90(6)); and
- Under s. 88(1) (in respect of an exclusionary provision) or under s. 88(8) (in respect of conduct to which s. 47(6) or s. 47(7) applies) unless it is satisfied in all the circumstances that the proposed provision or conduct would result (or be likely to result) in such a benefit to the public that the proposed contract, arrangement or understanding or conduct should be allowed (s. 90(8)).

In reaching its decision on whether or not to grant authorisation, the Commission has examined the MSOR carefully and, as outlined in section 2 of this *Final Determination*, has taken account of written and oral submissions received from the applicant and other interested parties.

The MSOR are instrumental to the implementation of market carriage in Victoria. Market carriage, with an independent systems operator and a spot market to settle imbalances, represents an important component of a package of reforms implemented by the Victorian Government, which aimed to create competitive natural gas wholesale and retail markets in Victoria.

It is anticipated that these markets will develop further. The introduction of new sources of gas and the commencement of full retail contestability should assist this process. As the market develops the benefits of the MSOR and market carriage generally should become clearer.

The Commission is satisfied that there are tangible benefits flowing from the MSOR.

These are:

- efficient gas balancing;
- improved network services;
- efficient medium and long term development of the gas market;
- openness and transparency of the MSOR;
- promotion of price discovery;

- the maintenance of consistency with current arrangements; and
- the facilitation of retail competition.

However, several issues have the potential to detract from the public benefit associated with the MSOR. These are:

- the provisions relating to the liability of interested parties;
- the ramifications of single zone daily pricing arrangements;
- the current arrangements relating to transmission rights;
- the complexity of the MSOR; and
- the need for greater end user representation.

In relation to the first of these, the Commission has required adjustments to the MSOR as a condition of authorisation. In relation to the second and fifth, the Commission has not imposed conditions of authorisation, but has recommended that VENCorp take action to address these issues. The third issue, transmission rights, is likely to be addressed in the first instance by way of changes to the current pricing mechanism. If these do not occur, however, the Commission has recommended that VENCorp review this issue. The Commission considers that the fourth, complexity of the MSOR, is necessary and justified in the circumstances.

As outlined in section 5.2 of this *Final Determination*, the Commission assesses the net public benefit and detriment likely to flow from the proposed arrangements by applying the 'with and without test'. This process involves comparing the MSOR in their current form with the counterfactual.

This process is rendered more complex by the Commission's finding that there is a range of counterfactual scenarios.

If the counterfactual is another form of market carriage, only one of the benefits outlined above is likely to occur – the maintenance of consistency with current arrangements. The others would be likely to occur under any form of market carriage. The Commission is unable to ascertain whether these remaining benefits would be more likely to occur under the current arrangements than under an alternative form of market carriage.

However, the Commission considers that maintaining consistency with current arrangements represents a benefit to the public. If the counterfactual is another form of market carriage, the benefit of maintaining consistency means the avoidance of a situation where the Commission's failure to authorise the MSOR would necessitate further measures by VENCorp and the Victorian government to continue some form of market carriage arrangements. However, this situation is likely to dislocate the Victorian gas industry less than a move to contract carriage. This means that the likely scope of this benefit to the public is less than if the counterfactual were contract carriage.

If the counterfactual is another form of market carriage, the Commission is unable to state which, if any, of the possible public detriments would occur. Again, this is because it is unclear precisely what species of market carriage would eventuate if the MSOR were not authorised.

However, the various possible forms of market carriage are unlikely to differ significantly in their potential to breach the TPA. Therefore the net public detriment in this instance is likely to be negligible.

If the counterfactual is contract carriage, the Commission considers that all of the potential benefits and detriments listed above are likely to occur.

Although the Commission considers that some aspects of the proposed arrangements and conduct contained in the MSOR may lessen competition and/or constitute an exclusionary provision or exclusive dealing, it considers that subject to the conditions listed in section 8 of this *Final Determination*, in all the circumstances the MSOR is likely to result in:

- a benefit to the public which outweighs the potential detriment from any lessening of competition that has resulted from the operation of the MSOR, or is likely to result from the continued operation of the MSOR; and
- such a benefit to the public that the MSOR should be allowed.

Because the Commission considers that clause 3.1.3 of the MSOR has the potential to detract from the net public benefit resulting from the MSOR, authorisation is subject to condition C6.1.

Furthermore, as discussed in section 7 of this *Final Determination*, the Commission considers it appropriate to require condition C7.1, relating to the period of authorisation, as a condition of authorisation.

Conditions of authorisation

C6.1 It is a condition of authorisation that clause 3.1.13(d)(1) be amended to provide, relevantly:

due to a technical fault or failure or *force majeure event* which was outside the *Market Participant's* control.

This clause is to be read subject to the obligations placed on *Participants* by clause 6.7.2.

VENCorp may comply with this amendment by adopting either Option 1 or Option 2.

Option 1 - By amending the MSOR to reflect condition of authorisation C6.1 by no later than 8 months after this *Final Determination* comes into effect: or

Option 2 - By agreeing to an alternative wording with Esso that addresses Esso's concerns in relation to situations generally considered to be *force majeure* situations, and submitting the proposed change to the GMCC within 5 months of this *Final Determination* coming into effect. The proposed change must be approved by the GMCC and VENCorp's Board of Directors within a further three months.

If Option 2 is pursued but not completed within 8 months of this *Final Determination* coming into effect, then condition C6.1 must be implemented without delay.

C7.1 Authorisation of the MSOR is granted until 31 December 2012.

9. Final Determination

For the reasons outlined in this document, the Commission grants authorisation for applications A90831, A90832 and A90833, subject to the following conditions:

C6.1 It is a condition of authorisation that clause 3.1.13(d)(1) be amended to provide, relevantly:

due to a technical fault or failure or *force majeure event* which was outside the *Market Participant's* control.

This clause is to be read subject to the obligations placed on *Participants* by clause 6.7.2.

VENCorp may comply with this amendment by adopting either Option 1 or Option 2.

Option 1 - By amending the MSOR to reflect condition of authorisation C6.1 by no later than 8 months after this *Final Determination* comes into effect: or

Option 2 - By agreeing to an alternative wording with Esso that addresses Esso's concerns in relation to situations generally considered to be *force majeure* situations, and submitting the proposed change to the GMCC within 5 months of this *Final Determination* coming into effect. The proposed change must be approved by the GMCC and VENCorp's Board of Directors within a further three months.

If Option 2 is pursued but not completed within 8 months of this *Final Determination* coming into effect, then condition C6.1 must be implemented without delay.

C7.1 Authorisation of the MSOR is granted until 31 December 2012.

This *Final Determination* is made on 18 December 2002. If no application for review is made to the Australian Competition Tribunal, it will come into effect on 8 January 2003. If an application for review is made to the Tribunal, the *Final Determination* will come into effect:

- where the application is not withdrawn – on the day on which the Tribunal makes a determination on the review; or
- where the application is withdrawn – on the day on which the application is withdrawn.

Appendix A. Submissions

The following parties made public submissions in relation to the Market and System Operations Rules:

AGL Energy Sales & Marketing Limited: 28 June 2002;

Department of Natural Resources and Environment, Victoria: 14 August 2002;

Duke Energy Australia Pty Ltd: 13 May 2002;

Energex Retail Pty Ltd: 17 July 2002, 16 September 2002; 5 December 2002;

Energy Action Group: 19 August 2002;

Energy Users Association of Australia: 6 August 2002;

Esso Australia Pty Ltd: 19 July 2002; 8 November 2002

GasNet Australia (Operations) Pty Ltd: 11 July 2002;

TXU Australia Pty Ltd: 17 July 2002, 5 September 2002; 5 December 2002;

Victorian Energy Networks Corporation (VENCorp): 17 May 2002, 19 August 2002; 5 December 2002; and

Visy Paper Pty Ltd: 23 July 2002.

Appendix B. Interested parties consulted by the Commission

The Commission met with the following parties to discuss the authorisation application:

AGL

Duke Energy

EAG

Energex

Esso

EUAA

GasNet

Headberry Partners

Institute of Public Affairs

TXU

VENCorp