

TXU Australia Pty Ltd
ABN 96 071 611 017
Level 33
385 Bourke Street
Melbourne Vic 3000
Tel: 03 8628 1000
Fax: 03 8628 1050

17 July 2002

Ms Kanwaljit Kaur
General Manager
Regulatory Affairs – Gas
Australian Competition and Consumer Commission
PO Box 1199
Dickson ACT 2602

Dear Ms Kaur

**Re: CA2002/582
VENCORP Application for Re-Authorisation of MSOR**

Thank-you for the opportunity to comment on the VENCORP application for Re-Authorisation of the MSOR. As you are most likely aware, TXU is an active player in the Victorian energy market, with substantial holdings in the gas industry, including:

- A gas distribution network
- Contract for gas supply at Longford
- Rights to LNG for peaking supply, and obligation to fund the portion of LNG reserved for system security purposes
- Substantial portfolio of large and small gas retail customers amounting to more than a third of the Victorian retail market
- An obligation to supply gas to Victorian gas fired electricity generators
- The WUGS underground gas storage facility.

With such a diverse set of interests in the Victorian gas market we believe we have a very broad view of the issues facing gas in Victoria. We have directed our response to the MSOR Re-Authorisation application accordingly.

Summary of TXU Position

TXU urges the ACCC to re-authorise the MSOR for a 10 year period without delay. There are 2 primary reasons for this:

- Any other outcome leads to uncertainty for participants in Victoria's gas market, and increased costs in taking part in an extended regulatory process. This can be ill-afforded in an environment where Full Retail Competition is about to commence and there is significant investment in new supply and increased gas-fired generation.
- Further, the Victorian gas market as governed by the MSOR is fundamentally working at present. In TXU's view, the market is transparent and open with low barriers to entry, and contributes to a competitive environment at the wholesale and retail level. In fact the single greatest inhibitor of dynamic competition in the Victorian gas market, and indeed the South East Australian gas market, is not the market model but continues to be the lack of upstream competition.

While TXU is of the view the MSOR governs a market which is fundamentally operating effectively, TXU does continue to have reservations in relation to the single daily price and the much debated limitations of the market carriage system for transportation capacity rights. We believe the impact of these limitations will grow over the next few years. Therefore, TXU requests the ACCC mandates, as a condition of authorisation, a move to hourly locational pricing by 1 December 2004. TXU believes this is essential to:

- Provide a market design which allows gas to be transported for a firm price, which presently cannot be done due to “surprise” uplift;
- Provide a transportation capacity management system which places clear incentives on the pipeline owner to make the most efficient use of their pipeline assets, which the present system of AMDQ does not;
- Provide rational economic signals within-day for new gas supplies, which will increasingly be called for peaking supply within-day, and peaking gas-fired electricity generation which is also often a “within-day event”. At present, the economic signals for the rational scheduling of these supplies/loads are muted or distorted and difficult to manage due to the single daily ex-post price.

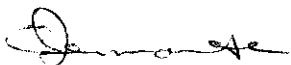
TXU recommends a 2-step process to achieve this. The first step would be to prepare a market design and implementation plan, by 1 December 2003. This may include a limited trial. The second step would be to roll-out and implement the required changes such that operation under an hourly locational market commences by 1 December 2004. Implementation by this time allows 2 clear years from the scheduled time of completion of the ACCC re-authorisation and appears entirely achievable given that substantial work has already been undertaken in relation to hourly and locational pricing and much of the IT software is already in operation.

Our more detailed views on these topics are attached in our detailed submission.

Conclusion

TXU appreciates the opportunity to comment, and trusts the ACCC finds our submission helpful and constructive. We welcome any questions you may have. Please feel free to contact Peter Carruthers, Gas Trading Regulatory Manager, on (03) 8628 1244 for any follow up.

Yours Sincerely



Caryle Demarte
General Manager, Government and Regulatory Affairs

Detailed Submission

TXU's detailed submission is organised as follows:

- Section 1 – The Need for Certainty
- Section 2 – The Need for Hourly/Locational Pricing
- Section 3 – Additional Comments on Other Issues

We have not attempted to address all the issues raised by the ACCC in the Issues Paper, but instead have restricted our remarks to critical areas and those areas where we felt we could add value to the ACCC's deliberations.

1. The Need for Certainty

1.1 *The Absence of a Clear Counter-Factual*

The "counter-factual" is the corner-stone of the ACCC's public benefit test required for authorisation. The ACCC defines the counter-factual as "the situation which would exist in the future if authorisation were not granted...", and makes its assessment of the net public benefit by comparing the MSOR with the "counter-factual". In its original authorisation of the MSOR in 1998, the ACCC used a contract carriage model as the counter-factual. However, on this occasion, VENCORP has submitted that contract carriage should not be used as the counter-factual and instead a different form of market carriage should be used. The ACCC has sought views in its Issues Paper on the relevant counter-factual.

This is a key issue, and strikes right at the heart of our arguments about the need for certainty. Indeed, it is most unclear what situation would exist if the authorisation were not granted. As such, it is very difficult to identify a sound counter-factual. The following sections outline TXU's views on the counter-factual and the uncertainty which would arise if authorisation of the Rules was not granted.

1.2 *Alternative Models not Feasible*

The key reason it is difficult to identify a meaningful counter-factual is that the current market design is effectively "locked-in", through a combination of laws, codes and property rights. For example:

- the separation of the ISO from the pipeline operator is locked in through the Victorian Gas Industry Act and through the fact that GasNet is a publicly listed company trading with a particular regulatory model and risk profile. It would require substantial will and effort to change this.
- The MSOR itself is given effect by Victorian law
- Participant processes and IT systems rely on the market as defined by the MSOR – substantial costs would be incurred if an alternate model was implemented
- We suspect that once an alternate model had been developed to sufficient detail, there would be a number of other impediments identified, most likely to do with property rights. A possible example, depending on the nature of the alternate model selected, might require re-allocation of LNG rights.

It is clear that an alternate market model could not be developed and implemented without extremely wide-spread support, and this support would need to commence with the Victorian State Government. It is TXU's understanding that the Victorian Government has no intention of embarking on a course of action which would lead to substantial change before 2007, when there is a statutory requirement for the Part 8 of the Gas Industry Act to be reviewed. TXU understands this will include a review of the role and functions of VENCORP, with particular regard to the competitiveness of markets for or in relation to gas.

In TXU's view therefore, a contract carriage model is not a meaningful counter-factual as it is simply not practical to implement it in the current environment.

1.3 Uncertainty – the Likely Outcome if the MSOR is not Re-Authorised

If the Commission was to not authorise the MSOR, then TXU believes a very substantial period of uncertainty would result. If authorisation was not granted, a process would need to be established which involved the Victorian Government, the ACCC, the ESC, industry participants and users to determine what to do. Options would be analysed and possibly an alternate model may be flagged. If work on an alternate model were to proceed, leadership of the process and funding for the process would be required. Currently, to the best of our knowledge, there is no funding in place and no leadership or management process for such a project to occur in a controlled manner. It is unclear to us how a controlled, managed process would be established if the ACCC were to not authorise the MSOR. TXU has substantial experience in similar regulatory situations where leadership, accountability, decision making, funding and cost recovery were not fully defined and clear up-front, such as electricity FRC, and respectfully suggests it is essential a similar situation be avoided.

Further, the significant project which would be required to define and implement an alternate model, at this time, would be a considerable distraction to all participants in the Victorian gas market at a time when focus is required to deliver such important initiatives as FRC and peaking generation for Victorian electricity consumers.

The statutory review of the GIA, led by the State Government, is indeed the appropriate managed process for a wide ranging review of the effectiveness of the statutory and regulatory framework that governs the Victorian gas market and VENCORP. TXU is comfortable with this and urges the ACCC to participate proactively in that review at the time, with a view to ensuring duplication of consultation and decision-making processes is avoided. TXU's present view is that it does not rule out any particular gas market models from this review.

On the basis of the above, TXU submits that the counter-factual is not clear. Indeed, it is hard to avoid the conclusion that the situation which would arise if the MSOR were not re-authorised (ie. the counter-factual) is uncertainty.

1.4 Effectiveness of the MSOR

TXU acknowledges that the operation of the market has limitations. These limitations are reasonably well known and understood by informed stakeholders. They relate to the effect of the simplified single daily price, the need for uplift to capture and recover the externalities of network constraints and with-in day balancing decisions, and the resulting inadequacies of the transportation capacity rights system. We outline our views on these limitations and our recommended solutions in more detail in Section 2 below.

Notwithstanding these limitations it is TXU's view that, overall, the MSOR is working effectively and is consistent with TXU's pro-competition philosophies. Now that the market has been in operation for some 3½ years it is easy to take for granted some of the attributes and benefits, but in our view they include:

- Transparent price discovery
- Facilitation of new retail entrants to the market, (providing they are able to procure gas supply, which we note is limited by the lack of genuine upstream competition)
- Facilitation of spot trading
- Transparent and market-based scheduling of gas injections
- Support for retail competition, as both the spot market and the market carriage models allow participants to trade easily out of contracted positions (or avoids locking them into contracted positions in the first place).

1.5 Conclusion and Term of Authorisation

TXU strongly recommends that the MSOR is re-authorised without delay. The reasons outlined above support this recommendation, and in summary are:

1. The MSOR is, overall, working effectively and delivering benefits to the operation of the gas market in Victoria. Limitations can and should be addressed as a condition of authorisation; and
2. The alternative to the MSOR is uncertainty. We submit that there are very substantial benefits in avoiding such a period of regulatory uncertainty and maintaining the current arrangements. The appropriate review point is the Government-led statutory review.

TXU supports VENCORP's recommendation that the MSOR be authorised for a 10 year period, for the reasons outlined by VENCORP in its submission. This will provide certainty for participants through to the completion of the Government review in 2007. Should the Government review mandate change, then a re-authorisation can be sought at that time.

2. The Need for Hourly/Locational Pricing

TXU has noted, and participated actively, in the previous debates on the need to move to hourly and locational pricing. The 2 main reviews conducted under the auspices of VENCORP's Gas Market Consultative Committee, the "Locational and Hourly Pricing Review" (December 1999) and the "Review of the Victorian Gas Market Arrangements" (March 2001), both concluded that there was not a sufficiently strong case to justify a move to hourly and locational pricing.

TXU contends that is no longer the case. There are very clear drivers now, which arguably were not as clear or pressing at the time of the previous reviews, which make a transition to hourly and locational pricing essential. There are 3 key reasons which are outlined below:

- firm transportation
- controllable loads, particularly gas-fired electricity generation
- new gas supply entrants.

2.1 Firm Transportation

As has been pointed out by the advocates of the contract carriage model, a shipper is unable to ship gas for a firm price within the Victorian market. This is caused by the limitations of the single daily price market model. This model gives rise to potential “surprise” uplift charges, where the costs of intra-day scheduling actions required to balance the system are recovered through a smearing mechanism socialised across the market. An example is the injection of LNG to maintain system pressures where there has been a forecast error. This market design limitation is generally well understood by informed market participants and is referred to by the ACCC in its MSOR Issues Paper in section 3.5.1 – Single Zone Pricing.

We note VENCORP’s point that uplift charges have, to date, been low. However, the issue is not one of quantum, it is one of risk and certainty. Past performance is not necessarily a guide to future performance and the risk of significant costs flowing through the uplift mechanism remains. It is a difficult risk for shippers to manage and it is not possible to hedge against it. This is a material issue when it comes to managing customer relationships and even attracting new investment to Victoria.

TXU contends that current developments in the gas market will exacerbate the situation. These developments include:

- Increased inter-connection with other States and pipelines
- New supply side entrants, often being established to serve a particular customer load
- Increased demand side entrants, such as gas-fired generation.

Each one of these situations will have an increasing call on the need for firm transportation. If the physical network capacity is available, then the shipper should be able to procure rights to firm transportation. For example, it would appear logical that a gas-fired generator should be able to secure firm gas transportation rights to gas for peaking summer-time electricity generation, given that there is ample summer-time pipeline capacity.

We note the current work being performed on the Uplift Trial. While it is likely that this will assist in reducing the potential exposure, the risk is not removed.

TXU advocates adoption of the hourly/locational pricing model, with a well-defined transportation capacity rights system, as the best mechanism to solve this problem. This model has been discussed at some length, and is outlined in “Review of Victorian Gas Market Arrangements” (VENCORP, March 2001).

2.2 Controllable Load/Gas-Fired Generation

TXU is aware more than most of the inefficient nature of the single daily price, which provides no economic scheduling signals at the hourly level, due to its obligation to supply gas to significant Victorian gas-fired generators.

Remembering that electricity generators are self-dispatched, it is vital for these generators that they have access to appropriate price signals to ensure efficient scheduling of dispatch. In the electricity market, price signals are real-time. This contrasts starkly with the gas market where the gas price is set on a daily basis, and determined ex-post the following day. Hourly pricing signals in the gas market are internalised and smeared back across the market through the uplift charge, which is not known until the following day. Gas-fired electricity generators are therefore working blind to an extent on their true costs of gas supply. Inefficient scheduling decisions unavoidably result.

The situation now becomes much more significant with the construction of 2 new gas fired electricity generators (Somerton – 150MW and Valley Power – 300MW). Further gas-fired

generation is likely in the near future given Government policy in relation to GreenHouse Gas Emissions, its subsequent support for gas fired generation (which TXU endorses) and the need to supply increasing summer electricity peaks.

It is TXU's view that the gas market needs to converge with the electricity market to allow for efficient scheduling of gas-fired plant. Near real-time gas pricing is required, so that gas-fired electricity generators can make rational commercial decisions in relation to their plant. Harmonisation of the energy markets needs to take another step and, to do this, the Victorian gas market needs to move to hourly and locational pricing.

2.3 New Supply

Victoria needs new sources of gas supply. This is required for the following reasons:

- To support increased consumer demand for gas arising from economic growth
- To support significant new gas loads such as gas-fired electricity generation
- To support diversity of supply as part of stimulating competition and ensuring security of supply.

Much of this is "peaking" supply, required only for a portion of the day. In some cases it may be required during peak winter gas times eg for supplying increased consumer demand. Other cases may require the demand at non-peak gas times, such as gas-fired generators which are more likely to be consuming gas during summer. Either way, the gas is required for only a portion of the day. Clearly the current daily price does not capture the effect of within-day events through the market price and cannot do so while a single daily gas price is set. Also, the locational investment signals for that gas source are muted.

Again, TXU advocates an hourly/locational pricing model as the most appropriate solution to sending clear economic signals for new gas supply entrants.

2.4 Recommended Steps

TXU believes the case for moving to an hourly and locational pricing model is clear. This will assist in resolving a number of the limitations with the present market design which have been widely debated and criticised, as well as positioning the market for dealing effectively with the new likely developments.

There have now been 2 reviews of this issue, conducted under the auspices of VENCORP. TXU is not critical of those reviews or the way in which they were conducted, but believes a further review would not be productive at this time and recommends it is now time for action. To this end, we recommend the ACCC mandates, as a condition of authorisation, that a transition to hourly and locational pricing with a well-defined transportation capacity rights system is implemented. We offer the following points for the Commission's consideration to outline why we believe a further review will not be productive and a condition of authorisation for hourly/locational pricing is appropriate:

- The environment and market has changed since the previous review – there is new gas-fired generation on-stream, more gas-fired generation likely and new sources of gas supply imminent;
- The business case for moving to hourly/locational pricing is difficult if a purely quantitative view is taken. The costs of transition can be identified relatively easily, but the benefits case is more qualitative. In particular, a benefit case taking a forward-looking competition-oriented perspective is essential. A strategic perspective is required;

- Left in the control of the participants, it is likely there will be little incentive to change unless or until significant amounts flow through the uplift mechanism. Our concern is that, by then, it will be too late to give effect to the necessary changes. In addition to the increasing influence of new supply and gas-fired generation, possible scenarios generating higher levels of uplift include substantially colder winters (the last 3 have been very mild when compared with long-term averages) and the ever-present possibility of plant failures. Participants inevitably seek to minimise their costs and are significantly influenced by a “look-back” perspective – and the “look-back” period was characterised by statistically mild winters and relatively little gas-fired generation. A lack of will to change from participants is understandable and to be expected, but not necessarily in the best long-term interests of the market.

For these reasons we believe it is necessary a strategic perspective is taken and it is appropriate for regulatory guidance on this matter, taking account of the benefits to competition of the hourly/location pricing model with a well-defined capacity rights system.

We recommend that operation of the market under this model commence by 1 December 2004, with an interim date of a market design and implementation plan being prepared by 1 December 2003. Our basis for recommending these dates is twofold:

- We recognise that there has been substantial work undertaken on the hourly/location model but that it is not complete and further work is required. This could be undertaken through 2003, including a trial if deemed appropriate;
- We recognise there is likely to be implementation work required from participants and VENCORP, whether that be IT systems, establishing transportation capacity contracts, etc. 12 months is an adequate time for these preparations.

Our recommendation of 1 December as the commencement date is somewhat arbitrary, but has been suggested as: (i) it is in a non-peak period; (ii) it allows several months of trading before the onset of the peak winter period; and (iii) it is an easier date from an implementation perspective than a date selected in or shortly after the traditional Christmas/January holiday period.

In our view, implementation any later than December 2004 would be too late, as the market developments referred to will be impeded by that time if a single zone daily price remains in effect.

We recommend that this work be performed under the governance of the normal MSOR change control mechanisms, including the VENCORP Board, the GMCC and subsequent ACCC approval using the processes which have worked successfully to date for rule changes.

3. Other Issues

3.1 AMDQ Trading

TXU notes that trading of tariff D customer Authorised MDQ (AMDQ) is now possible within the Victorian gas market, overcoming a very significant previous limitation. However, we believe 2 difficulties remain:

- AMDQ is allocated to the customer. Customers appear reluctant to release AMDQ in situations where they are not using it and have little incentive to do so. This is demonstrated by the lack of AMDQ Trading so far;
- Obtaining access to transportation capacity in non-peak times such as summer, when there is substantial spare pipeline capacity, is not possible.

This gives rise to a situation where (i) shippers are unable to adequately procure AMDQ, even in instances where there is ample physical capacity available; and (ii) there are inadequate incentives on the pipeline owner to optimise the use of their pipeline asset.

TXU believes these problems would be solved with a move to hourly/locational pricing supported by a well-defined capacity rights model. We have outlined our views on this in Section 2 above. In advance of this move however, it is TXU's view that more can be done and we request the ACCC consider the following to address these issues:

- Consider a mechanism which provides additional incentives for customers to release AMDQ through the existing market-based mechanism in situations where they are not using it;
- Review the model which allocates tariff V AMDQ for periods of the year when it is not used, for example, summer. This point was noted in VENCORP's "Review of Gas Market Arrangements (p. 33, March 2001) and TXU believes it should be followed through.