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July 19, 2002

Ms. K. Kaur
General Manager
Regulatory Affairs - Gas
Australian Competition and Consumer Commission
PO Box 1199
DICKSON ACT 2602

Victorian Gas Market System
Operating Rules application for
authorisation from January 1, 2003

Dear Ms. Kaur,

I refer to the VENCorp application to the ACCC for the authorisation of the Victorian Market System Operating Rules (MSOR) dated 17 May 2002 and attach our submission which details our concerns, issues and recommendations in order to assist the ACCC in its decision.

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. A contract carriage system for Victoria, consistent with systems in other states, would provide benefits by enabling parties to obtain firm transmission rights to back gas sales contracts, to relate gas production to contractual obligations and to equitably share and mitigate risk and liabilities. This in turn would encourage appropriate and efficient industry development and interstate trade.

We encourage the ACCC to determine that the MSOR should only be authorised for a period to enable the full implementation of a contract carriage system. For this interim authorisation period we strongly recommend that the ACCC impose conditions that provide protection and reduce liability exposures of market participants in a shortfall situation, and provide a level playing field and equitable distribution of risks for market participants including producers.

I thank the ACCC for its letter of 27 June 2002 granting us an extension to 19 July 2002 for making our submission which has enabled us to raise our concerns and issues.

Yours faithfully,

F. Slebos

Frank Slebos
Gippsland Gas Marketing Manager
Esso Australia Pty Ltd
For and on behalf of
Esso Australia Resources Pty Ltd

Authorisation of the Victorian MSOR dated 17 May 2002 by the Australian Competition and Consumer Commission

Submission by Esso Australia Pty. Ltd. 19 July 2002

Introduction

On 20 May 2002, VENCorp made application to the Australian Competition and Consumer Commission (ACCC) for the authorisation of the Victorian Market System Operating Rules (MSOR) dated 17 May 2002 under subsections 88(1) and 88(8) of the Trade Practices Act 1974. VENCorp has applied for the authorisation to apply for a period of ten years commencing 1 January 2003.

To assist the ACCC in its decision over the authorisation of the MSOR, the ACCC promulgated an Issues Paper dated June 2002 and has sought public comment in the form of written submissions from interested parties.

ExxonMobil's subsidiary Esso Australia Resources Pty. Ltd. has been a major producer and supplier of natural gas to the Victoria since 1969, to New South Wales since 2000 and will soon commence supply of gas to Tasmania. Esso as a continuing major producer and supplier of gas in Victoria has a significant interest in the Victorian gas industry and its market system. We believe the decision the ACCC will make is of vital importance to the efficient and competitive development of gas market in Victoria and for interstate competition.

Executive Summary

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. The MSOR is unnecessarily complex and does not allow the normal industry processes of bilateral agreement and contracting between parties, which would enable parties to obtain firm transmission rights to back gas sales contracts, to relate gas production to contractual obligations and equitably share and mitigate risk and liabilities. We believe that a contract carriage system for Victoria consistent with systems in other states would provide these benefits and therefore encourage industry development and interstate trade.

We appreciate that the implementation of a contract carriage system in Victoria with the necessary bilateral arrangements and the winding back of the MSOR may take approximately two years. We therefore believe the ACCC should determine that the MSOR only be authorised for a period to enable the full implementation of a contract carriage system. While the MSOR remains in place, albeit for this interim period, we submit that in order to ensure the best possible market liquidity and therefore market outcomes the issues raised within this letter must be addressed. Specific issues with the MSOR being relief from failure to comply with scheduling instructions for force majeure events and interruptible supply, and a balance of liabilities between parties limited to direct damages only. Other fundamental issues such as the ability of any market participant to obtain a capacity allocation to back a gas supply contract where redundant capacity is available and allocation of uplift charges should also be addressed.

Appropriate MSOR counterfactual

We disagree with the VENCorp proposal that the ACCC should consider the only counterfactual to the existing Market Carriage system as being other market carriage systems. We strongly believe that the ACCC in its review of the MSOR should compare the proposed MSOR against what would be in place if the MSOR were not authorised. Clearly if the MSOR were not authorised, individual gas customers, retailers, producers and pipeline operators would be required to enter into separate bilateral contract arrangements covering supply, demand and balancing issues without the need or encumbrance of a market operator. This contract carriage model is the traditional model that is in place elsewhere in Australia and most common around the world. The MSOR is a costly and inefficient mechanism for managing system imbalances and a spot market.

Timing Considerations

We recognise that the MSOR is currently in place and the ACCC is to decide on the authorisation of the system from January 1, 2003. While we believe it is in the powers of the ACCC to require a change to a contract carriage system, we believe it would take approximately two years for the necessary bilateral arrangements between gas users, gas retailers, gas transporters, pipeline owners and gas producers to be established. The ACCC may therefore need to consider a transition period for the conversion from the MSOR to a contract carriage system.

We also believe it is within the ACCC powers to authorise the MSOR as has been submitted or with required changes for a period determined by the ACCC. We note that VENCorp have applied for the authorisation period to be 10 years. Should the ACCC authorise the MSOR we would strongly recommend a significantly shorter period. VENCorp suggest in their submission that the MSOR has now been in operation and has proven effective for 4 years and so propose authorisation for a further 10 years. We strongly disagree that the effectiveness of the MSOR has as yet been tested fully. The key benefits the MSOR was supposed to deliver are the facilitation of full retail contestability and provision of system balancing through dispatch from multiple sources. VENCorp describe the MSOR as tested, yet full retail contestability has not yet been implemented in Victoria, to date there are very limited base load gas supply sources with historic supply arrangements, and the transmission system is essentially unconstrained with excess capacity. The MSOR will not have been fully tested until each of these elements has changed. As such any authorisation of the MSOR should be limited to a period that allows it to be tested under these changed elements and ensures that a review is conducted in a timely manner to assess whether the MSOR has been successful in delivering the described benefits. Therefore the ACCC should consider in its assessment of an authorisation period: (i) the introduction of full retail contestability later this year; (ii) the planned introduction of gas from new sources such as Patricia Baleen, Yolla and Minerva in the next few years; and (iii) the cessation of the historic base load gas supply arrangements late this decade. The ACCC should also consider the planned review of the role of VENCorp by the Victorian Government which we believe will take place in around five years time. Any authorisation of the MSOR beyond this review would essentially make it superfluous as it is the MSOR that requires an independent system operator and defines its role.

Fundamental Concerns with Market Carriage and the MSOR

We believe that in its review of the MSOR and its comparison to an alternative contract carriage model the ACCC should consider the gas industry's fundamental issues. Gas industry issues with the MSOR were described in the Allen Consulting Group's report titled "Review of the Victorian Gas Market" dated March 2001. This report was completed for the Victorian Gas Industry and Users Steering Group which includes a wide range of market participants from end users, retailers, transmission system owners to producers. We understand that a copy of this report was presented to the ACCC around mid 2001.

While the Allen Consulting Group's report is fairly comprehensive in nature we highlight our chief fundamental concerns which revolve around the MSOR's complexity, the inability to obtain firm transmission rights to back gas sales contracts, the disconnect between dispatch and contractual obligations and uplift payments. Each of these areas we believe add significant risk and uncertainty to the gas industry in Victoria and deter efficient investment, interstate trade and market liquidity. Our fundamental concerns with the MSOR are as follows;

1. The high complexity of the MSOR places a significant burden on the participants, particularly when compared to simple access arrangements of the other Australian States (NSW and soon to be SA through the SEA gas pipeline) with which gas is traded. The high complexity of the MSOR and the significant difference between it and access arrangements in other Australian States and indeed other jurisdictions around the world act as an encumbrance to interstate flow of gas and act as a deterrent to investment by large gas users, pipeline owners and gas producers.

   While public information suggests development commitments have been made for the Minerva, Yolla and Patricia Baleen gas fields each should be considered in context. Public information suggests that the Minerva and Yolla fields have both committed to South Australian gas users while Patricia Baleen gas will flow to NSW gas users. Indeed we believe Minerva gas will flow through the new SEA gas pipeline and Patricia Baleen gas will flow through the EGP without the necessity of entering the Victorian pool under the MSOR. While Yolla gas will be required to be bid into the Victorian pool under the MSOR, it should be noted that it is owned and operated by a significant Victorian gas retailer (Origin Energy) and may provide this retailer with an opportunity to offset some of their pool risk through vertical integration of gas production.

2. Under the MSOR it appears that the only way a Market Participant can obtain firm pipeline capacity rights (AMDQ) to back a delivered gas sale under the MSOR such that the rights do not belong to the end customer, is through paying for a pipeline extension or expansion. Where there is additional capacity in an existing pipeline the AMDQ will be allocated to the end customer and the Market participant being a gas producer or retailer is unable to obtain capacity rights to back the delivered sale. In many instances gas users may prefer to offset their risk through contracting gas on a delivered basis. Under these circumstances gas sellers can best minimise their risk and therefore provide the highest level of service to the customer through contracting directly firm capacity rights with the pipeline operator to back the contracted gas sale. This normal process of allocation and offsetting gas transmission risk is not provided for under the MSOR. The MSOR would

seem to encourage inefficient system investment as the only way for a Market Participant to obtain firm transmission rights through payment for pipeline extensions or expansions and which may not otherwise be required.

This issue is exacerbated for interstate gas sales. In these circumstances a gas seller will be required to obtain firm contracted capacity rights on interstate pipelines to back the delivered gas sale but can not do so on the Victorian pipelines. A simple example can be demonstrated for a delivered gas sale from a gas field outside Victoria to a gas end user within Victoria. Firm pipeline capacity rights are contracted by the gas seller for transmission of the gas to Victoria, however these cannot be matched within Victoria without payment for system expansion or extension even if capacity exists within the system. In the case that existing system capacity is utilised and the end customer ceases to exist or is captured by another gas retailer, the AMDQ within Victoria is lost or transfers with the end customer, while interstate capacity rights and obligations remain with the original gas supplier. The result being that the original gas supplier may have interstate capacity payment obligations with little or no ability to utilise as the necessary back to back arrangements are not available in Victoria without payment for system extension or expansion.

A similar situation can be envisaged for a Victorian gas supplier providing gas to an end customer interstate. We believe that the risk of interstate trading in gas through the Victorian MSOR is significant and counter to benefits that could be gained through Victoria adopting a contract carriage model consistent with other states.

3. Dispatch and therefore production throughput is not guaranteed as it is based on the market participant's bids to the system and not contract commitments with the field. In theory to ensure dispatch the market participant may bid zero price for their base load volume. However, this will not ensure dispatch of the entire volume if demand is low and several market participants have also bid their volume in at zero. Under these circumstances the dispatched volume from each of the participants where bids are the same is prorated. All market participants and gas producers must under these circumstances reduce their injection even where the reduced demand is caused by a lower demand by a particular gas end user or market participant not directly related to them. Under a contract carriage system a reduction in demand is directly assigned under the contract from the end user to the particular contracted gas producer.

4. The potential of high uplift charges caused by dispatch of a higher priced gas supply (eg. LNG, WUGS) as a result of a constraint in the system that limits the supply of lower cost gas. In this situation while the unconstrained market price would reflect the lower cost supply that would have been dispatched, all market participants are allocated a share of the increased cost through an uplift charge. This general allocation occurs where an individual cause cannot be determined or where the constraint was caused by VENCorp. An example of this situation could be VENCorp erroneously forecasting demand where temperatures are forecast to be higher than actual. In this situation, particularly in winter, VENCorp may not order sufficient line pack gas to enable the lowest cost gas producers to fulfill the actual demand. As a result of this constraint caused by VENCorp, VENCorp will call on higher cost LNG or WUGS to stabilise the system, ensuring that uplift charges are made on all market participants. This essentially amounts to cross subsidisation, as in

this instance, the additional demand due to the lower than forecast temperature is likely to be caused by the more temperature sensitive residential load.

We believe that each of the above instances can be more appropriately managed through a contract carriage system, whereby risk, including that attributable to volume and cost, can be directly allocated to the appropriate parties. Under a contract carriage system all price and balance issues are agreed between the parties and importantly are quantified and costed ensuring risks are minimal to the parties. The contract carriage system would represent a lighter handed regulatory approach by allowing market forces and competitive responses to determine market outcomes through a wide range of bilateral contract agreements. We believe such a system would therefore be beneficial to the Victorian gas industry by encouraging interstate gas trading and ensuring that eastern Australia with its interconnected gas systems act as an efficient market which in turn will encourage investment.

Upstream development

The type of gas market model that would provide appropriate encouragement for upstream investment and competition should be an important consideration to the ACCC in its decision on the authorisation of the MSOR. In its decision on the authorisation of the MSOR or a change to a contract carriage system, the ACCC should consider the impact on upstream exploration and development.

Upstream companies such as Esso face significant risk and expenditure through the exploration phase with essentially all of the investment required before any revenue from production is obtained. To avoid the risk of a stranded investment, it is industry practice in non liquid markets to underpin investment by long term sales contracts prior to commitment of major field development funds. This risk is naturally offset in world crude oil markets and in some regional gas markets, for example the United States, through mature and high levels of market liquidity. Victoria and Australia are characterised by essentially non liquid gas markets and so long term bilateral contracts are required to minimise production and sales risk, and to provide sufficient revenue certainty to encourage developments. Such bilateral contracting covers supply from the field and transmission to the customer and provides the various parties with a reasonable certainty of supply and revenue, and an agreed balance to minimise risks and liabilities.

A traditional contract carriage system would provide sufficient certainty of production and transmission, along with a balance of minimised risks and liabilities, to encourage upstream investment and competition. The MSOR does not. We observe that the new upstream developments in offshore Victoria (Patricia Baleen, Yolla and Minerva) were only committed after long term sales contracts were secured, most of them outside Victoria.

Arguments posed in favour of the MSOR propose that it will assist full retail competition and that the Victorian market is different from other markets in that there is limited line pack and so more dynamic balancing is required. However, we highlight that full retail competition is to be implemented within New South Wales under the existing contract carriage model. We also highlight that, while we believe any balancing needs can be met through appropriate contracting, since the implementation of the MSOR, significantly more supply options have been added with interconnects and storage. Since the introduction of the interconnects and

storage there is now less reliance on the Longford - Dandenong pipeline line pack and any requirement for its special balancing role of the past has been alleviated. Hence past justification for the MSOR is no longer valid and we believe the benefits of moving forward under a contract carriage model as outlined above, provide an irrefutable argument in its favour.

Specific issues with the MSOR

Where the ACCC authorises the MSOR for a period there remain key specific issues with respect to provisions within the MSOR that act as deterrents to gas producers becoming market participants providing gas directly into the market pool. These issues apply specifically to gas producers and significantly increase producer risk. While gas producers are not direct market participants it is unlikely that the full potential market liquidity will ever be achieved. We believe that any authorisation by the ACCC of the MSOR, even for a limited period until a further review or revoking of the MSOR, must include a revision to address these key and substantive producer issues which revolve around relief from failure to comply with scheduling instructions and limitation of liabilities. These risks would be significantly reduced under a contract carriage system where they would be fairly and equitably allocated between the parties best able to manage the risk under their bilateral arrangements. Details of these specific issues with the MSOR are provided below:

a) Relief from failure to comply with scheduling instructions

Standard industry provisions of force majeure provide a balanced protection for gas producers, pipeline operators, gas retailers and end users to provide relief from obligations which they are unable to perform due to events beyond their control. The MSOR does not provide such balanced force majeure provisions and we submit that this acts as a significant barrier, in particular, to producers becoming direct market participants bidding gas directly to the pool and adding valuable liquidity to the market.

The only protection that is granted to all market participants from meeting their obligation to comply with a scheduling instruction is under clause 3.1.13(d). Part (1) of this clause provides limited protection to all market participants where the event was due to a technical fault or failure which VENCorp's opinion is outside the market participant's control. Part (2) of this clause provides protection to a market participant where its contract with a producer is a reasonable endeavours contract only. Clause 3.1.13 (e) provides for the market participant to be liable for penalties where they do not comply with a scheduling instruction to which relief under clause 3.1.13 (d) (1) and (2) do not apply.

Neither part (1) nor part (2) provide a market participant with adequate protection for a force majeure event which is a fundamental principle in gas supply contracts. A market participant that is not a producer has some protection under part (2) where its gas supply contract is on a reasonable endeavours basis however whether a force majeure provision within a firm sales contract would define supply under that contract to be on a reasonable endeavour basis may be open to legal interpretation and argument. In any case, part (2) provides no protection for a producer bidding gas directly into the gas pool. Therefore under a force majeure event, protection for a producer, and most likely a market

participant, will be determined under part (1) and VENCorp's opinion as to whether the event was due to technical fault or failure outside the parties control. This places a very significant risk on market participant and in particular producers where force majeure clauses are the industry norm and allow the affected party to be relieved from its obligations in a force majeure event. Industry standard force majeure clauses typically include, but are not limited to, relief for failure to perform as a result of industrial action (strikes, bans, lockouts, etc.), acts of god (storms, storm warnings, cyclones, etc.), acts of public enemy (wars, terrorist activity, etc.), accident, failure, breakage or malfunction, and Government action or inaction.

Without force majeure protection for market participants and in particular producers, significant additional risk is born by them in bidding gas to the market. In the case of producers it is a substantive disincentive to bidding directly to the pool, ensuring that the market will see only limited liquidity.

An additional issue with the MSOR and in particular clause 3.1.13(d) part (1) and part (2), is that is does not specifically allow interruptible gas to be bid to the pool by market participants (including gas producers and gas retailers). While part (2) may provide some relief in this respect for market participants contracting with gas producers, gas producers are provided with no ability to bid interruptible or non firm gas directly into the pool. Market participants and in particular gas producers, offering interruptible and non firm gas into the pool would add additional liquidity to the market and competition for the supply of balancing gas.

b) Limitation of Liability

Standard industry provisions provide for a balanced share of liabilities between gas producers, pipeline operators, gas transporters, gas retailers and end users. Typically each party's liabilities are limited to direct costs and explicitly exclude consequential losses including loss of profit. The MSOR provides total protection to VENCorp. While some limitation of liability is provided to retailers and gas transporters under the MSOR and Gas Industry Act 2001, there is no protection provided to gas producers. The MSOR therefore does not provide a balanced sharing of liabilities and places significant risk on producers. Such risk again acts as a significant barrier to producers becoming direct market participants bidding gas directly to the pool and adding valuable liquidity to the market.

Under the Gas Act and the MSOR VENCorp are charged with the responsibility for managing the system including determination of system requirements for a day, receipt and dispatch of market participant nominations, system security, acceptance of off-specification gas and system planning. Yet, while VENCorp has such a key management role, which could significantly affect market participants and end gas customers, the MSOR including clause 1.2.2 almost totally limits VENCorp liability. Clause 1.2.2 of the MSOR generally limits VENCorp's liability to specific provisions within the MSOR and to amounts it can recover from participants or the proceeds of insurance.

Key examples of the inequity of the sharing of liabilities are in the areas of scheduling nomination and off-specification gas. In the area of scheduling nominations, specific

provisions contained in clause 3.3.6 of the MSOR, limit VENCorp's liability to an amount from a "participant compensation fund" which is derived from participant payments. While inappropriate scheduling could have a significant detrimental effect on market outcomes, on system security or on an individual market participant or end customer this limitation extends to cover scheduling errors by VENCorp. In the area of off-specification gas, which again could have a significant detrimental effect on an end customer or the transmission system, VENCorp's liability is limited under clause 1.2.2 to amounts it can recover from participants or the proceeds of insurance. This limitation extends to cover VENCorp even where it has accepted the off specification gas for delivery into the system and in this case amounts are not provided under the "participant compensation fund".

In contrast, in both areas of delivery to a scheduling instruction or of off-specification gas, the MSOR provides no limitation to the liability of market participants even in the case of off-specification gas where they have complied with an instruction or a prior acceptance of VENCorp. This represents an imbalance in the sharing of risk between VENCorp and the market participants.

In its consideration of the appropriate balance of liability, limitations of liability and risk, the ACCC should review the relevant sections of the Victorian Gas Industry Act 2001. Section 58 of the Victorian Gas Act 2001 allows for the recovery of unlimited damages from market participants where they have contravened a conduct provision of the MSOR. A contravention of a conduct provision could be interpreted to include non compliance with a VENCorp scheduling instruction or delivery of off-specification gas. This unlimited liability placed upon market participants including producers where they are bidding gas into the pool is not the industry norm whereby damages are typically limited to direct damages only. However, section 232 exempts gas retailers from liability for failure to supply, while section 233 exempts gas transmission companies from liabilities for failure to accept, transmit or allow withdrawal of gas, each where failure arises out of accident or is beyond their control. While sections 232 and 233 provide some exemption of liability to retailers and gas transmission customers, it is not provided to other market participants that are categorised under clause 2.1 (c) of the MSOR as Producers, Traders, Transmission Customers, Distribution Customers and Storage Providers. The Victorian Gas Act 2001 therefore exacerbates the imbalance of liabilities between VENCorp and each of the market participants and while the ACCC is only charged with the authorisation of the MSOR, it should carefully consider changes to the MSOR that would more equitably distribute risk and limit liabilities.

Without an appropriate balance of liabilities between market participants and appropriate limitation of liabilities to direct costs with explicit exclusion of consequential losses including loss of profit, market participants and in particular producers, bear substantial additional risk under the MSOR. Such additional risk would be more equitably balanced under more standard gas market systems and in particular contract carriage systems. Again this acts as a disincentive to producers becoming direct market participants, bidding into the pool and adding valuable market liquidity.