



Department of Natural Resources and Environment

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Dear Ms Kaur

Victorian Gas Industry – Re-Authorisation of Market and System Operations Rules

I refer to the Commission's consideration of the application from the Victorian Energy Networks Corporation (VENCorp) for the renewal of the authorisation in respect of the Market and Systems Operations (MSO) Rules for the Principal Gas Transmission System (PTS) in Victoria for a ten year period commencing on 1 January 2003. The ACCC originally authorised the MSO Rules in 1998.

The MSO Rules provide for managing the capacity of the PTS as a Market Carriage Pipeline. The ACCC's Issues Paper for the Application for Re-Authorisation of the MSO Rules seeks comment on the rationale for applying Market Carriage to the PTS, including whether the characteristics of the Victorian gas industry necessitate Market Carriage with an independent system operator, and whether an alternative configuration could adequately address the needs of the Victorian gas market. VENCorp has provided substantial submissions to the ACCC on the rationale for Market Carriage and the relevant characteristics of the PTS. This letter provides additional comments on the statutory framework for Market Carriage and some general comments on re-authorisation issues.

Market Carriage is the mandated mechanism for managing capacity over the PTS. The MSO Rules are part of the Government's legislative framework for the gas industry. The MSO Rules were initially made by an Order in Council under section 48N of the Gas Industry Act 1994, and amended under that section and (since 2001) under section 52 of the Gas Industry Act 2001. The MSO Rules are part of the broader arrangements in Victoria which establish VENCorp as an Independent System Operator with a statutory obligation to control the operation of the PTS.

Market Carriage was developed as part of a series of structural reforms to create a competitive market for the sale of natural gas in Victoria. 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. The provision of a wholesale market in gas over the PTS under the MSO Rules supplements the general market for gas. As noted by the ACCC in the 1998 authorisation, the MSO Rules play a role in encouraging diversity of supply in the Victorian gas industry.

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Market Carriage was developed and adopted in Victoria because it met the requirements of the PTS which is a network characterized by multiple supply points and multiple off-take points. In those circumstances, Contract Carriage, which operates primarily on point to point pipelines, was not a viable option. Moreover, Market Carriage was seen as best meeting Victoria's long-term policy aims, including the introduction of full retail competition and the encouragement of a diversification of supply sources. These are still Victoria's aims and as such Market Carriage remains the preferred option within Victoria for the PTS.

The introduction of Market Carriage on the PTS was a relatively novel approach to transmission pipeline capacity management, given that the other gas transmission systems in Australia were understood not to exhibit significant network characteristics. The competitive market model was also introduced at a time when competition reform had only recently been applied to the gas industry. The opposition to its adoption expressed in 1997 and 1998 was therefore understandable. Since that time, the benefits of Market Carriage have become evident and the model has been supported by both traditional gas industry participants and new entrants. The AGL and TXU submissions to the ACCC on the authorisation application are examples of the support.

There are still those who are opposed to the adoption of Market Carriage. However, suggestions that Contract Carriage should be adopted now are inconsistent with the Government's objective of establishing an open access gas market operating on a competitive basis. The Government therefore remains committed to Market Carriage.

The National Competition Council (NCC) examined Market Carriage in 1999 as part of the certification process in respect of compliance of the Victorian Access Regime with the third party access provisions of the Trade Practices Act. The NCC concluded that the Market Carriage arrangements were consistent with the competition principles under national competition policy and that the trading arrangements do not pose a barrier to interstate trade in gas.

As noted in the AGL submission on this matter, stability in the market structure is important. The role of VENCORP in the gas market will be reviewed in 2007. The principal matter to be addressed in the review is whether there is a continuing need for VENCORP or a similar statutory authority having regard to the competitiveness of the markets for and in relation to gas.

The current position is that VENCORP must operate the PTS under the MSO Rules. The PTS is a Covered Pipeline for the purposes of the National Third Party Access Code for Natural Gas Pipeline Systems. The Code provides for Access Arrangements to be based on Market Carriage if permitted by the relevant Minister in the jurisdiction. Both the Victorian and NSW Ministers have given that permission.

In the period since 1998, the operation of the PTS system under VENCORP has proven to be a workable and effective model. VENCORP has been responsible since that date for the security and reliability of gas supply over the PTS. VENCORP's role has also provided transparency and accountability in the operation of the PTS and the associated wholesale gas market. In that time, the arrangements for the supply and sale of natural gas have worked relatively smoothly and successfully, with only one occasion on which VENCORP has had to intervene in the normal operation of the market. This occurred on 22 July 2002 when, due to a coincident combination of a number of influencing factors, VENCORP declared a level 5 gas emergency and

implemented Table 1 of the published curtailment tables. VENCORP has submitted a separate report to the ACCC on this incident, which is published on the VENCORP website.

The Government considers that VENCORP has performed its functions satisfactorily to date. The MSO Rules and independent system operator (ISO) model have promoted the development of a more competitive gas market, with system operation processes that provide open access and are market oriented. The MSO Rules and ISO model have the general support of the industry and are attracting new entrants in both the supply and retailing of gas. The Government does not propose at this time to consider an owner/operator model for the PTS. In these circumstances, the Department supports the submission by VENCORP that the appropriate counterfactual for the current application for authorisation is a different version of Market Carriage.

The ExxonMobil submission to the ACCC with regard to the current MSO Rules authorisation application repeats arguments that Market Carriage fails to provide firm transmission rights and thereby discourages upstream investment, efficient transmission system investment, interstate trade and market liquidity. The VENCORP application for authorisation of the MSO Rules deals with many of the issues raised in the ExxonMobil submission. NRE understands that VENCORP will provide further responses to the ACCC in this regard.

The TXU submission proposes that the MSO Rules be authorised on the condition that hourly locational pricing be introduced by 1 December 2004. The proposal is based on a concern for firm transportation capacity rights. VENCORP has addressed this issue in its application, and will provide further details in its response to issues raised in submissions by other parties. For the purposes of this letter, it is noted that Market Carriage was introduced using a system of uniform daily pricing. It was expected at the time that hourly and locational pricing would be introduced over time to improve the efficacy of market pricing signals and enable better management of residual commercial risk. The MSO Rules required that VENCORP review the scope for developing the market along these lines.

A comprehensive "Market Review" was duly undertaken by VENCORP through an open and consultative process, involving the Gas Market Consultative Committee ("GMCC" – see below), the public release of issues papers and consideration of submissions by interested parties. The final report¹ concluded that, while there were potential benefits in moving to a locational/hourly pricing model, there was insufficient participant support and no clear cost/benefit justification for doing so at that time. This position is capable of review within the framework of the MSO Rules and the Market Carriage arrangements.

VENCORP's operation of the wholesale gas market is overseen by an independent Board incorporating representatives of participants in the gas market. The Board has established a Gas Market Consultative Committee (GMCC) as a participant-representative forum to review the gas market design and operation and recommend changes for ongoing development of the market to meet stakeholder requirements. The GMCC was responsible for the review of the pricing arrangements referred to above, and provides a sound forum for addressing market development issues, including many of the issues raised by the ExxonMobil submission.

DNRE supports re-authorisation in respect of the MSO Rules. The MSO Rules are an integral part of the market structure in Victoria designed to foster competition and facilitate the introduction of contestability into the gas market. Re-authorisation will provide for ongoing confidence in the industry and the further development of the Victorian gas market.

¹ "Review of Victorian Gas Market Arrangements"; VENCORP, 15 March 2001.

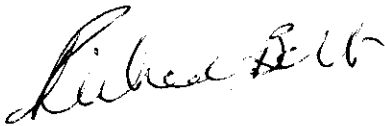
Term of Authorisation

DNRE supports VENCORP's application for a 10 year authorisation of the MSO Rules. It is noted that authorisation for 10 years would save conflicts with the review of VENCORP's Access Arrangements in 2007, and the review in 2007 of VENCORP's role as required by Gas Industry Act. It is noted also that any consequential effects of those reviews can be addressed in revisions to the MSOR framework, with appropriate applications for authorisations if necessary.

GasNet has lodged a submission which argues that a re-authorisation should run no later than 31 December 2007. GasNet notes at paragraph 4.2 of that submission that the current Service Envelope Agreement expires in December 2007. The Service Envelope Agreement sets out the basis on which the PTS is made available to VENCORP. GasNet also asserts that it has no understanding or arrangement with VENCORP in relation to the continuation of the Service Envelope Agreement, and that there is no certainty as to the terms on which VENCORP will be able to obtain the availability of the PTS after 2007, and that any re-authorisation beyond then may inadvertently imply that the Service Envelope Agreement should continue.

Clause 5.3.1 of the MSO Rules requires in part that "VENCORP and a Transmission Pipeline Owner must enter into a service envelope agreement, and thereafter must at all times ensure that there is a valid service envelope agreement in force between them." Clause 5.3.1 represents a legal requirement that GasNet must comply with, in particular that there must be a Service Envelope Agreement in force on a continuing basis. The clause represents Government policy in the sense that it goes hand in hand with the establishment of VENCORP as an Independent System Operator.

Yours sincerely



Richard Bolt
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