5 December 2002

Mr Russell Phillips
Acting General Manager
Regulatory Affairs – Gas
Australian Competition and Consumer Commission
PO Box 1199
Dickson ACT 2602

Dear Mr Phillips

Re: CA2002/582 - VENCorp Application for Re-Authorisation of MSOR
TXU Submission on the ACCC's Draft Determination

TXU endorses the thrust of the Commission's conclusions in the MSOR Re-Authorisation Draft Determination. We believe the Commission generally understands the key issues and has structured its draft determination accordingly.

In our response to the Commission's Draft Determination, we would like to comment specifically on the interim authorisation, the period of authorisation and the market model.

1. Interim Authorisation

If a final determination and authorisation of the MSOR is not in place by 1 January 2003, TXU submits that it is essential that an interim authorisation be granted. An interim authorisation would simply maintain the status quo of the market. We believe this meets the ACCC's criteria for granting an interim authorisation ie. there are no issues that would prevent the market from returning to its pre-interim authorisation state if final authorisation was later denied or would permanently affect the competitive dynamic of the market. Conversely, there are considerable legal issues for market participants and the market operator, which may well flow on to operational issues, if an authorisation is not in place from 1 January 2003.

TXU requests that the Commission provides certainty on this matter by no later than 13 December 2002, and earlier if at all possible. If there is any risk that an authorisation will not be in place, then contingency plans will need to be developed immediately and put into action prior to 1 January 2003.

2. Period of Authorisation

TXU endorses the Commission's recommendation in the draft determination that the MSOR be re-authorised for a 10-year period. We note that this does not mean the MSOR is necessarily locked-in in its current form for that period, as:

- The MSOR will continue to change and develop through the GMCC and Rules change process
- The statutory review scheduled for 2007 requires a comprehensive overall review of the market structure and design and
- The option exists for an authorisation to be revoked should this be necessary or appropriate.

These points provide comfort to TXU that there is sufficient opportunity for review and change should circumstances demand. We believe this should provide adequate comfort for other stakeholders concerned about the length of the authorisation period too.

TXU supports the 10-year authorisation period as it provides for a certain and known environment and minimises the costs/distractions of an additional resource consuming authorisation review process under circumstances where little value would be added. For example if authorisation was granted for 8 years and re-authorisation was locked in as a requirement for 2010, the industry would be subject to reviews as follows:

- Comprehensive statutory review under the GIA, conducted in 2007 and likely to take most of the year as it runs its submission, reporting, consultation and decision processes
- VENCorp/GasNet Access Arrangement reviews also performed during 2007
- ACCC authorisation process in 2010, again likely to consume regulatory resources over the course of the year as has occurred under the current re-authorisation process during 2002
- The authorisation process in 2010 could potentially commence as soon as 2 years after the statutory review is completed
- 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!

TXU submits that any of these scenarios would be a reflection of poor planning and forethought, a significant drain on the resources of stakeholders and the regulator, would increase investment uncertainty in the Victorian gas industry and ultimately would add little value.

We urge the Commission to maintain its view that a 10-year authorisation period is appropriate.

3. Market Model

TXU has strongly and consistently advocated the need for the MSOR to move from its single zone daily pricing market carriage model to a more robust model that provides better pricing signals and a robust transportation model. We note the Commission's discussion of the issues in its draft determination and commend the Commission for its serious treatment of such a substantive issue.

However, TXU continues to encounter limitations associated with the current market carriage model. In our supplementary submission of 5 September 02 we outlined the limitations of the daily spot market price signals as demonstrated by the events of 22 July.

In this submission, we would like to focus in on the limitations of the current market carriage transportation model. The net effect is further reinforcement of our key message that the market model must move on and (a) provide better pricing signals and (b) a robust transportation model. The implications for investment and operation in Victoria over the forthcoming years will be significant if the model remains in its current form.

We explain our case below, organised in the following sections:

- The need for better pricing signals from the market
- The limitations of the current market carriage model in relation to pipeline capacity expansions and therefore the need to establish a more robust transportation model
- Harmonisation with the electricity market
- Our concerns in relation to timing
- Our suggestions to the ACCC on how to strengthen its recommendation to review the cost/benefit associated with a move to an hourly/locational model.

3.1 Better Pricing Signals

Our supplementary submission, dated 5 September 02, highlights the issues exposed by the events of 22 July. The Commission has picked those issues up and we believe the issues are now reasonably well understood by a range of stakeholders.

We argued in our supplementary submission that events like 22 July are increasingly likely to occur. System capacity is increasingly likely to be fully utilised and constrained as new supply sources come on stream, gas-fired generation increases, robust load growth continues and inter-connected system shipping demands become commonplace. The choice facing the market, and the market operator, is to either transition the model to one which incentivises rationale commercial responses, or to increasingly intervene in the market such as in the case of 22 July. There is of course no choice – it is essential the market transitions to a model that provides meaningful price signals to incentivise rational on-the-day and investment responses.

3.2 Pipeline Capacity Expansions

The issue of a robust transportation model has received some attention in the ACCC's draft determination, in the sections on Capacity Rights and Single Zone Daily Price respectively. However, we believe there are further issues which have not been adequately addressed that are worth drawing to the Commission's attention.

In particular, it is becoming clear that the current market carriage arrangements provides very little support – to the point of acting as a disincentive – for pipeline capacity expansions in situations where they are clearly warranted.

Broadly, the MSOR in its current form provides for the allocation of AMDQ to a user who invests in the expansion of pipeline capacity. This is intended to provide the investor with a property right entitling them to firm access to the pipeline system equivalent to the MDQ increase resulting from the investment. In practice, TXU believes this approach is ineffective and simply does not work, because of the following:

Surprise Uplift. AMDQ provides protection against congestion uplift but not surprise uplift. As has been widely acknowledged, very little congestion uplift occurs in the Victorian system with most uplift being surprise uplift. Therefore, the AMDQ allocated provides little protection against uplift and therefore has little value.

Involuntary Curtailment. In light of the emerging dynamic in the South-East Australian gas and electricity markets, it is likely that pipeline expansion will be driven by the needs of investors looking to ship gas across the inter-connected system or to supply gas-fired generation. Any gas being shipped through the pipeline which is destined for export to another pipeline or for a large gas-fired generator (existing or new) will be assigned to Curtailment Table 1. In the event there is a system problem and pressures are low, the export or gas-fired generator is involuntarily curtailed first, as we saw on 22 July. Effectively, the gas being injected is requisitioned and re-allocated to users lower down on the curtailment tables who remain on the system - without appropriate market or contractually based financial compensation.

Free-Riders. Other users are able to "free-ride" on the investment, using the increased capacity without sharing any investment risks (eg take-or-pay risk), due to the common carriage aspects of the market carriage model. This acts as a deterrent to investing, as it provides other pipeline users with a free-ride. The practical effect of this limitation is that rational capacity expansion investments will likely be deferred until constraints become unsustainable and intervention is commonplace.

In addition to these problems, the very nature of the current market arrangements means that it is unclear which parties have the incentive to invest in capacity expansion. In fact, under the present implementation of market carriage, pipeline capacity is shared on a common basis until a constraint occurs. AMDQ provides protection (ie a right) only in the event a constraint occurs. If a clear property right existed to the capacity of the pipeline, it would be clear to each party whether they needed to invest in pipeline expansion.

The issues of pipeline capacity property rights, firm access and incentives to expand pipeline capacity are typically dealt with robustly under a contract carriage model. TXU is not advocating a return to a contract carriage model, but believes it is essential that the current market carriage model be enhanced to provide a transportation model that deals with these issues appropriately.

These issues are inseparable from the hourly/locational issues raised above in section 2.1. Constraints or the potential for constraints give rise to the need for pipeline capacity expansions. These constraints occur between locations and occur at an intra-day level. Any solution developed must deal with both the transportation issues as well as the intra-day/locational issues jointly.

One possible approach to providing a robust transportation model is to enhance the market model to provide for Financial Transmission Rights (FTRs) in conjunction with an hourly/locational market.

Providing the FTRs are appropriately designed and allocated, it should be possible to deal with the issues raised above.

Regardless of the approach finally adopted, it is essential that mechanisms that provide for transportation certainty and investment incentives are in-built into the model used in Victoria.

3.3 Harmonisation with the Electricity Market

TXU notes the Commission's discussion of the MSOR's relationship with the electricity market. We support the Commission's analysis and believe that harmonisation with the electricity market will not occur until an hourly/locational model (or similar) with firm FTRs or similar can be established.

3.4 Timing Concerns

The ACCC recommends that VENCorp conduct a cost/benefit review of moving to a more robust market model commencing no later than 30 June 03. If the review does commence in June 03, then the likely timing is as follows:

- Allowing 9 months for review and decision means the review would be completed early 2004
- Allowing 2 years for piloting, regulatory approvals, detailed design, implementation and cutover would mean that a revised model would be implemented some time from around early 2006.

TXU submits this is too late.

The demands and pressures on the current market model are increasing even now. They will forcefully be felt as soon as the Victorian system is inter-connected with (a) NSW via VicHub and the EGP and (b) SA via SEA Gas. Both these initiatives will be in place by January 2004.

TXU urges the ACCC to alter its recommendation in relation to the timing for the cost/benefit review to bring it forward. TXU suggests it is more appropriate that the cost/benefit review be commenced by 1 March 2003 and completed as soon thereafter as practicable. Such a recommendation would send a clear signal of the ACCC's view of the urgency of the matter and assist in providing impetus and momentum.

3.5 Cost/Benefit Review

TXU believes that the impact of the current market model's limitations will become considerable over time, both from the perspective of managing on-the-day events and in terms of investment in the system. TXU expects that, in time, this will flow on to investment in Victoria. TXU continues to believe public benefit would result from the ACCC mandating a change to hourly/locational with a robust transportation model and is disappointed the ACCC rejected that suggestion. TXU acknowledges the Commission's reasons for that decision.

Nevertheless, given the fundamental importance of the market model implications and timing issues outlined above, TXU suggests the Commission strengthen its recommendations in relation to the cost/benefit review, by:

- Emphasising for clarity that the review is to take account of deep long-term forward looking economic benefits and not just consider uplift costs
- Recommending the review be commenced by 1 March 2003 and completed as soon as practicable (as outlined above in section 2.4), rather than commenced by 30 June 03
- Requiring that, if the review results in a decision to maintain the status quo, the ACCC examines the decision to ensure that the review has properly taken account of overall economic efficiency arguments and the outcome has not been captured by entrenched participant positions
- Requiring that the review identifies how timely investment will occur in the absence of a more robust market model.

Conclusion

TXU appreciates the Commission's detailed consideration of the issues in its draft determination. We support the thrust of the ACCC's conclusions, and trust the Commission finds our further suggestions to be constructive and of value. We welcome any questions you may have. Please feel free to contact Peter Carruthers, Regulatory Manager Wholesale Gas, on (03) 8628 1244 for any follow up.

Yours Sincerely

Caryle Demarte

General Manager, Government and Regulatory Affairs