

The  
**Energy Action  
Group**

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**“Better Late than Never”**

Comments  
to the  
ACCC  
on the  
Re-Authorisation  
of the  
**Victorian gas MSOR**

19<sup>th</sup> August 2002

## Introduction

The Energy Action Group supports the EUAA submission on the Victorian gas MSOR.

The EAG recognises that there is a Victorian legislative requirement for the MSOR to run to 2007<sup>1</sup>. The market has already been operating for 4 years since it was authorised by ACCC in August 1998. We therefore suggest that the current arrangement only be authorised for the next five years with some strict conditions imposed to clarify some of the incomplete elements of the design. EAG recommends that a condition be imposed in the Determination to move the market forward, with the ultimate objective to get national gas market convergence across each of the jurisdictions.

This submission outlines some of EAG's unresolved concerns relating to the MSOR.

## EAG's perception of Market Risk

One of the most significant problems with the Victorian gas MSOR market design is that it allocates risk to retailers and D (Demand) customers who have little or no control over the magnitude of the risks involved. The retailers then add a risk premium into their retail offers in an attempt to hedge or mitigate those risks. Consumers have little or no control over the size of the premiums that they pay. D time of use metered customers have measurable exposure to Ancillary Service Payments and the Annual Maximum Demand Quantity (AMDQ) charges. A large number of D customers particularly industrial producers have a relatively flat predictable load over the year making load forecasting a relatively easy exercise.

However the significant increase in gas fired generators (D customers) provide substantial unpredictable load volatility over the year. These generators are dispatched by the National Electricity Market (NEM) Independent System Operator NEMMCo when their merit order bid price is reached. The generators can pass their cost through to the electricity market participants and even with dual fueling, their fuel costs are a small part of their cost structure, particularly when compared to their revenue potential given the \$10,000 VoLL cap in the NEM. This is in market contrast to other industrial D customers who cannot offset volatile energy costs on to their customers. It is difficult /impossible to predict the generators daily or annual consumption. D consumers with exposure to market volatility need to have access to real time pricing information to minimise their risks, so they can try to effectively minimise their energy costs. The current market

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<sup>1</sup> The ESSO/BHPP, GasCor gas contracts run out around this time frame as well. This contract underpins the gas allocations the cheapest gas available to the incumbent retailers Origin, AGLE and TXU. **This arrangement currently acts as a barrier to entry to 2<sup>nd</sup> tier gas retailers substantially reducing the competitive pressures in the Victorian gas market.**

arrangements do not appear to work well in this regard. The MSOR needs to protect the interests of D customers with flat non-volatile loads.

VENCorp Annual Gas Planning Review 2002 has projections for more gas fired generation. This development has the potential to expose the Victorian gas market, flat load D industrial customers with a flow on risk when the gas-fired generation operates. The daily ordering of gas increases this risk.

V (Volume<sup>2</sup>) customers increase their consumption when cold and minimise consumption when warm or hot. Retailers have to forecast daily demand by the start of the gas day betting against the accuracy of the weather forecast in their order for the gas day. The volatility risks are high when the Weather Bureau fails to forecast cold changes accurately. When the weather is warmer than forecast and the retailers have over ordered gas then the spot price is likely to be lower than the GASCOR contract price. If however the forecast is colder than forecast then the retailer could be exposed to a spot market with prices up to \$ 800/gj. The retailer assessment of this risk is factored into the gas price offered to all consumers. **The spot market design has substantial risk asymmetry between over forecasting or under forecasting gas day consumption. There are major implications for VoLL with the increasing influence of gas fired generation. The ACCC needs to ensure that there is a review of VoLL pricing arrangements and the risk implications of the daily gas market. Retailers have clearly factored in market design risks into their pricing offers.**

Any move from the daily market to an hourly locational market will clearly sharpen up prices. A number of consumers would have been exposed to \$ 800/gj on the 22 of July if the Victorian gas market had been using an hourly locational pricing at the time. Consumers need to be able to understand and control these risks to manage their financial exposure to the gas market. **The current cost smearing arrangements only mask these deficiencies in the current iteration of the market implementation.** The market risks will increase as the investors build more gas-fired generation to meet the projected shortfall in generation capacity in the Victorian Region of the National Electricity Market. **The complexity of the MSOR provided a lack of incentive and market signals to develop any demand side responses.**

It would appear that VENCorp has been managing the market to minimise risk by providing a reasonable spread of system pressure levels to meet the end of day linepac (system balance) requirements. This approach works well when they get the gas day forecasts right (approximately 99% of the time) and they budget extra gas to make up the low linepac pressure over the next gas day. The 22nd of July system management arrangements show what can happen if the system starts the gas day with low linepac and the Weather Bureau gets their daily forecast wrong. Unfortunately this approach has a flaw with increasingly convergent gas and electricity markets. The Victorian electricity region is using gas turbines as an increasingly more important source of supply to meet peak load electricity requirements. **Increasing amounts of gas-fired generation has the potential to increasing spot market volatility. The MSOR needs to resolve the**

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<sup>2</sup> This should stand for Volatile or Voters rather than Volume. (Jurisdictions appear to be reluctant to expose residential and small business consumers to market volatility.) The less than 5,000 gj/a customers respond to climatic conditions and the implementation of Net System Load Profiling smear the costs of volatile consumer behavior. There are few or no pricing signals for the less than 5,000 gj consumers.

### **allocation of costs associated with peak load electricity generation and other volatile loads.**

There have been two events in the life of the MSOR when gas fired power stations have dramatically lowered the linepac pressures over a short period of time.

The first event occurred on the 9<sup>th</sup> of November 2000, when the Latrobe Valley electricity workers restricted supply from the states' coal fired generators and the gas fired stations were dispatched for approximately 2 hours.

The second event occurred on the 22nd July 2002 when the interconnector between Victoria and N.S.W. was being maintained and one of the coal-fired stations was off for maintenance and the gas fired stations ran, while the weather bureau failed to get the forecast right. The gas fired generators operated without ordering sufficient gas causing a class 5 gas emergency.

The current GasNet ACCC Revenue Application clearly indicates that linepac will remain an ongoing issue for the MSOR and the market design.

One significant indicator of the general level of disquiet relating to the market arrangement has been demonstrated by the joint industry consumer commissioned Allen Consulting Report of May 2001 on the Victorian gas market. This consultancy demonstrated that the current institutional arrangement divide and conquer. There is the urgent need to develop end-user advocacy arrangements. If consumers at the time of the Allen Consulting Report had access to adequate funding, then that report would have been more robust in its analysis and recommendations of the MSOR. **EAG recommend the Determination provide for End User Funding similar to the NEM arrangements to resource consumer to participate in the market reform process.**

### **Comments on the Financial Market**

EAG is aware of the argument of many of the market participants (particularly members of Australian Financial Markets Association) and the rating agencies, who argue that regulatory uncertainty reduces the availability of long term financial hedge contracts, a valid argument. Therefore it is understandable that several submissions on the MSOR are recommending that the ACCC should move to a 10-year Authorisation rather than a more normal 5-year arrangement. EAG would however suggest that the small size of this market (approximately \$ 450 m/a worth of gas if bought under the GASCor Contract arrangements) acts as a deterrent to hedge contract arrangements and the development of a gas contract financial market. The different jurisdictional gas market arrangements minimise the development of a national gas financial market.

The EAG recognises that the ACCC has obligations under Part III A of the Trade Practices Act to approve arrangements that provide a competitive outcome. We would however point out that there are a number of perverse consequences of implementing the Victorian MSOR. A retailer wishing to trade in Victoria and New South Wales will have to build for the two radically different MSORs. South Australia and Queensland still have to decide their system balance /MSOR arrangements and if the trend for a different

MSOR is developed for these jurisdictions then the national retailer will have to develop four builds with a possible fifth for Western Australia.

One of the barriers to market entry is the price and complexity of the Information Technology (IT) builds to meet the requirements of the Independent System and Market Operator rules and codes. The Victorian FRC<sup>3</sup> looks like costing VENCORP, the 3 incumbent retailers and 3 distribution companies approximately \$250-300 m to build and operate systems to support the market over a five-year period. The value of gas sold through the market has an approximate value of \$2,250 m. The prohibitive IT costs to supply V customers, the restricted access of second tier gas retailers to the cheap GasCOR contract gas will restrict competition in Victoria until this contract unwinds.

ACCC has approved or will approve different market arrangements in each state. A national retailer will have to develop different contracts and trading systems to operate in each jurisdiction. ACCC has authorised “Competition between different market models” that entrench incumbent retailers” a non-competitive outcome with substantial wasteful IT costs.

**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.**

The market needs to be transparent to operate effectively. The Demand Side needs to be able to understand and minimise their risk exposure. The MSOR is yet to effectively define Ancillary Service (Constraint & Uplift) Payments and how they apply to the various parties. Consumers need to understand the AMDQ arrangements. The July 22<sup>nd</sup> event demonstrates that the process was far from transparent to the users on the system at the time! Consumers need to be able to firstly control or to hedge or as a last resort minimise their exposure to market risks.

Traditionally the major source of load volatility in the Victorian gas market has been the V (Volume/Voter) customers who rapidly respond to climatic changes. The MSOR forces the retailers to smear across this customer grouping. The jurisdiction has yet to address how the costs are going to be smeared amongst this customer grouping but it is clear that the approach will be consistent in minimising customer (voter) outrage! Usually reflected by a price cap approach.

The short term pricing approach by retailers for D (Demand) customers has been to build in a risk premium to cover perceived market events. The projected increase in consumption by gas fired generation has the potential to increase market price volatility and risks paid for by the remaining D customers. How do you allocate a 5-day MDQ when the plant only operates for 3 days for 12 months? This issue needs to be resolved in conjunction with the GasNet Revenue application.

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<sup>3</sup> It would be interesting to look at the N.S.W. arrangements in a similar manner! Currently it would appear that one retailer has over 95% of the market share.

The MSOR needs to ensure that customers can understand and control their risks. The network and gas market pricing exposure needs to be clarified to protect consumers from cross subsidies between the various classes of consumers.

An important offset is the ease of market access, amply demonstrated by the relative ease by which gas fired generation was able to access the Victorian gas market and the MSOR. Under normal circumstances the Contract Carriage market model provides considerably greater barriers to customer access.

## **VENCorp Accountability and Costs**

VENCorp needs to be more accountable. The current MSOR is complex and difficult, even for market participants to understand and control their own and consumer risks. The running costs of the market and the Independent System Operator are expensive, particularly when compared to the size of the market. There is no significant incentive for VENCorp to address the problems of market risk. There is no come back/liability for poor VENCorp decision making or dispatch allocation. The line pack management arrangements of the 21<sup>st</sup> and 22<sup>nd</sup> of July 2002 provides a simple and useful example to illustrate the point about limited liability. The objective of increasing VENCorp accountability is not to increase costs of operating the market and underwriting bad decisions<sup>4</sup>.

When the market complexity and expenses are added to the restriction of market access to cheap gas imposed by the GASCor/Esso BHPP contract, given that there are 3 incumbent retailers with access to the cheap gas, these arrangements minimise competition between retailers and act as a huge barrier to entry for second tier retailers. The complex and expensive IT builds for FRC acts as a further barrier to entry to second tier retailers minimising competition between retailers.

It is unlikely as a result of the current arrangements that there will be any significant savings available to pass on to consumers and Victorian competition will occur in name only.

Given that the MSOR and GASCor contracts have until 2007 to run then there is the time and the opportunity to develop a simple responsive market MSOR that could start after the unwinding of these arrangements.

**Therefore EAG recommends that the Authorisation only be for 5 years and that the Determination provide for resources for a review/project to simplify the MSOR to lower the barriers to entry, reduce market risks and costs<sup>5</sup>.**

**EAG is conscious that the “system balance rules” are a major issue across each of the jurisdictional gas markets and neither the market or contract carriage market models provide a simple relatively risk free approach to this issue. ACCC needs set**

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<sup>4</sup> Liability insurance for instance is rather expensive

<sup>5</sup> It is worth noting that the FRC costs should be close to fully depreciated over this time frame as well.

**in place a process that leads to a National approach to system balancing arrangements.**

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