22 October 2015

John Pierce
Australian Energy Market Commission
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Sydney South NSW 1235

Submitted online: www.aemc.gov.au

Dear Mr Pierce

EAST COAST WHOLESALE GAS MARKET AND PIPELINE FRAMEWORKS REVIEW – PIPELINE REGULATION AND CAPACITY TRADING DISCUSSION PAPER

Origin Energy Limited (Origin) welcomes the opportunity to comment on the Australian Energy Market Commission's (AEMC's) pipeline regulation and capacity trading discussion paper as part of its east coast wholesale gas markets and pipeline frameworks review.

Flexible access to pipeline capacity is a key feature of well-developed gas markets and important for the development of liquid commodity markets. It is broadly agreed that pipeline capacity trading is a key element that facilitates this flexible access.

The discussion paper describes the AEMC's concerns that the following three issues may be resulting in existing capacity not being held by the parties that value it the highest:

1. high search and transaction costs in the market for transmission capacity, particularly for shorter-term trades;
2. the lack of incentives to provide access by shippers that hold capacity; and
3. the lack of incentives to facilitate access by pipeline owners.

While the above represents the scope of potential concerns with current capacity trading arrangements, the materiality of some of these issues has not been proven to be conclusive. As such, it is difficult to justify some of the more heavy-handed regulatory options presented in the discussion paper. Consequently, Origin supports incremental improvements to existing arrangements, which generally lends itself to elements of Approach A over the significant regulatory changes in Approaches B and C. It is also important that a number of principles guide work in this area:

- the benefits of any proposed measures should outweigh the cost of implementation;
- property rights of existing capacity holders must be preserved;
- the potential impact of any contemplated change on future investment should be considered to ensure there are no perverse outcomes; and
- more interventionist policy measures should only be considered where other measures have proven to be ineffective (following a suitable period of observation) and the level of capacity trading is proven to be below an efficient level.

Approach A – facilitate trading between parties

Approach A presents options to address the AEMC's concern that high search and transactions costs in the market for transmission capacity, particularly for shorter-term trades, may represent a cause of inefficient allocation of pipeline capacity. Origin supports reducing search and transaction costs as an appropriate step to improving capacity trading. We consider this would complement the enhancements to information being considered under the proposed COAG Energy Council rule change.

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Standardisation of capacity rights

Origin supports the development of standardised secondary capacity contracts. We also support the development of standardised primary capacity contracts to the extent practicable. Compared with secondary contracts, a process to standardise primary contracts is likely to be administratively complicated and it is unlikely that all terms and conditions can be standardised; for example the discussion paper contemplates standardising locational characteristics within contracts but we suggest this could be problematic given the point-to-point nature of the east coast gas system. As such, there would need to be a process to scope common provisions across contracts to assess whether standardisation of each provision is possible or not.

While standardisation has its potential benefits, market participants should maintain the ability to negotiate contracts as appropriate. This is integral for contracts between pipeline owners and shippers, particularly foundation contracts to underwrite new investment, but is also relevant to contracts between two shippers to trade capacity.

Furthermore, consideration needs to be given as to how standardisation of contracts could be implemented practically. In Origin view's, existing contracts should be grandfathered and standardisation should only apply to new contracts.

Pipeline owners required to offer spare firm capacity in a transparent, open process

The AEMC proposes an auction process or other procurement mechanism could be used to offer spare firm capacity to the market. Origin supports improving transparency around the procurement process for spare capacity as long as the costs of periodically undertaking such a process are not prohibitive.

The discussion paper suggests the process by which spare firm capacity is offered to the market could be run by the pipeline owner or some other independent body such as the Australian Energy Market Operator in order to improve coordination across pipelines. Origin considers it appropriate that the responsibility for the procurement process remain with the pipeline owner. As long as the process is open and transparent, we do not envisage any particular benefits from coordinating across pipelines through an independent body facilitated process.

Information about available capacity and trades to be published through a bulletin board

Under this proposal, pipeline owners would be required to publish the quantity, price and terms and conditions of all firm and non-firm capacity available on their pipelines. Shippers would also be required to inform pipeline owners of all capacity trades between shippers and the terms and conditions associated with the trades, including the price.

A number of pipeline owners currently publish information on available capacity on their websites. Origin supports requiring that this information be provided in a central location in a standardised format. Standard information could include quantity, location, duration and terms and conditions but it must be recognised that this is only baseline information and there would still need to be the option to negotiate contract terms with a pipeline owner to reflect a customer's (i.e. shipper's) needs. There could also be some form of historical information provision around baseline quantities, locations and prices in order that prospective shippers can understand previous capacity availability to make more informed decisions.

For capacity trade information between shippers, this would only be workable for bare transfers and novations. Origin's preference is that this information be published on an aggregated basis for each pipeline, rather than for each individual trade, and limited to information on quantity and duration. In our view, this sufficiently meets the requirement of making available capacity positions known without making disclosing contractual positions. Given the enhanced information for gas capacity trading rule change proposes that pipeline owners provide a list of contracted shippers to the bulletin board, we suggest this could be extended to include any shippers reported as being in receipt of capacity through a bare transfer or novation. These two pieces of information should give a comprehensive view of past secondary capacity availability and current capacity holders at any point in time to allow prospective buyers and sellers to easily identify opportunities and make informed decisions.

Origin cautions against publishing information on prices or terms and conditions for individual capacity trades. We consider this information legitimately confidential. Publishing price information could put both parties to a capacity trade at a competitive disadvantage going forward. Presenting this information publicly is also problematic given prices payable under confidential contracts are reflective of the terms and conditions of the capacity trade and dependent on the prevailing market conditions.

In relation to terms and conditions, there is broad recognition across the market and for both parties to a contract that given their bespoke nature, bilateral supply, primary transport and secondary transport contracts are confidential. Furthermore, Origin is unaware of any calls to make the terms and conditions of any contracts public.

Voluntary surrender of capacity mechanism

This mechanism would oblige pipeline owners to accept capacity that a shipper does not require anymore and to try to re-sell the capacity on behalf of the capacity holder. Origin supports this proposal.

Approach B – improve the incentives of capacity holders in the provision of capacity

The AEMC intends for this approach to address a perceived issue of shippers having insufficient incentives to trade contracted but unutilised capacity. In Origin's view, shippers have a strong incentive to enter into secondary trades where capacity is not required for any particular period given a desire to recover some of their sunk costs. The options under Approach B, therefore, do not represent a proportionate response to any perceived issues around a lack of incentive to release capacity given the significant cost and complexity if these measures were to be implemented and that there is an inherent incentive for shippers to sell any spare capacity. A move to the heavy-handed approach set out in Approach B is not warranted and in any case would be premature given the less interventionist options set out in Approach A have not yet been tested. Origin is also conscious that these options have potentially detrimental implications for future investment decisions.

Oversell and buyback

This mechanism would require pipeline owners to make available additional firm capacity above the technical capacity limit of a pipeline. In our submission to the AEMC's public forum paper for its east coast wholesale gas market and pipeline frameworks review, Origin described some initial areas of concern with the oversell and buyback mechanism in relation to:

- flexibility – the mechanism may infringe on capacity holders' rights and impact a shipper's ability to respond flexibly over the course of a day;
- investment – the mechanism is currently applied to regulated transmission pipelines in Europe so may impact participants' willingness to contract firm capacity and therefore have perverse implications for investment signals and decisions in the Australian largely unregulated context;
- entry-exit system – the mechanism would be difficult to operate in Australia's point-to-point system; and
- Transmission System Operator (akin to a pipeline operator in Australia) estimation of capacity use – estimating available capacity could not be easily done with certainty under the point-to-point system and the potential for conservative estimation strategies to avoid having to buyback capacity when it is oversold suggests this mechanism may not be particularly efficient.

Firm day-ahead use-it-or-lose-it

Under this mechanism, a shipper would be required to nominate capacity to be used on a day before a defined cut-off time. After that time, restrictions would be placed on how much capacity can be re-nominated for that day. All of the shipper's unused capacity would be offered for sale in the market.

Origin does not support this mechanism as it impinges on existing capacity rights. Existing transportation contracts allow capacity holders to re-nominate on a firm basis as required to meet their portfolio needs. This re-nomination option would be lost, thus reducing a shipper's current flexibility to respond to changing supply and demand patterns on a day. This loss of flexibility undermines one of the key reasons why shippers purchase firm capacity in the first place.

It could be suggested that cut-off and re-nomination times could be defined to maintain shipper flexibility. Origin notes flexibility can be required throughout any given day and as a result, the task to define these times would be incredibly difficult, if not impossible.

Long-term use-it-or-lose-it

This mechanism would require shippers who seemingly systematically underutilise their contracted capacity to surrender a defined proportion of firm capacity back to the pipeline owner for resale to other shippers. The key problems with this option are how to measure capacity usage and what threshold should trigger this mechanism. Some of these problems arise from the seasonal nature of both gas and electricity usage on the east coast.

Origin also notes that the presence of unutilised capacity does not in itself suggest there is demand for that capacity. It would be unreasonable for shippers to forgo future flexibility if their unutilised capacity is mandatorily seized although there is no unfulfilled firm demand for capacity on the pipeline. If they were then required to recontract the firm capacity or were limited to only accessing potentially more expensive as available capacity, this could have significant financial implications for a business. In addition, the mandatory reacquisition of capacity when there is no unfulfilled firm demand could have implications for pipeline owner incentives around products offered and the price of those products.

Prohibit contractual provisions in GTAs which limit capacity trading by pipeline owners

The AEMC suggests the following provisions in contracts may be limiting pipeline owners' ability or incentive to enter into capacity trades:

- a direct prohibition on the pipeline owner selling capacity to another party;
- most favoured nation provisions, whereby foundation shippers are entitled to the prices offered by the pipeline owner to other shippers; and
- provisions that require the pipeline owner to rebate some or all of the revenue it receives from the sale of capacity to third parties back to the capacity holders.

Origin considers there may be value in understanding and evaluating the extent to which these provisions exist and how they may be limiting pipeline owners' ability or incentive to enter into capacity trades. We note, however, that some of these provisions are based on sound economic reasons and as such, we suggest any prohibition on these provisions requires careful consideration. Prohibiting these provisions could have adverse implications for investment as shippers may be unwilling to underwrite future investment if they feel others will benefit more from it and they could access the capacity at a cheaper price without underwriting it. It could also have implications for the price a pipeline owner is willing to offer for firm capacity.

As correctly noted in the discussion paper, prohibiting these provisions may help make as available capacity available to the market but would not necessarily alter the availability of unallocated, firm capacity offered by pipeline owners.

Reserve capacity for short-term trades

Under this mechanism, a fixed proportion of the total capacity on a pipeline would not be allowed to be sold as medium or long-term firm capacity and must instead be reserved for sale in the short-term. There are practical difficulties with this option in relation to both new and existing pipelines that could result in inefficient operation of pipelines. For the former, it would effectively require new pipelines to be oversized. For the latter, we question how it could be workably applied, particularly for fully contracted pipelines.

There is also the important question of who would bear the cost for this proportion of the pipeline's total capacity to be available for short-term sales. Requiring that the pipeline owner fund this proportion increases their risk as there is a possibility it may be unable to recover its costs. This is likely to undermine incentives for efficient investment. Likewise, it is not appropriate that those shippers with medium or long-term firm capacity bear this cost as they are not the beneficiaries of the service. This could undermine their incentives to enter firm capacity contracts and similarly, undermine investment.

Approach C – improve the incentives of pipeline owners in facilitating access to capacity

The AEMC intends for this approach to address the perceived issue of pipeline owners having insufficient incentives to facilitate access to capacity. Origin supports competition and sees regulation as only appropriate where there is a clear market failure and experience with other intermediary steps have proven unsuccessful. We also note that of the four and a half pipelines that are covered on the east coast, two are subject to full regulation and two and a half to light regulation. As a result, it is unclear how changes to pipeline owner incentives would lead to a different outcome for regulated pipelines or how it would impact currently unregulated pipelines.

Changes to the economic regulation of pipelines

The discussion paper explains that while the gas third party access regime may be fit for the purpose for which it was designed, it might not be targeted at other potential market failures in the gas transmission sector. Specifically, as it only considers competition in an upstream or downstream market, it does not currently consider whether a pipeline owner is, or could be, exercising market power in the provision of capacity. The discussion paper also suggests additional changes may be warranted to the nature of economic regulation that is applied to a pipeline; for example, in relation to the range of reference services provided.

Regulatory changes of this nature would be significant and require careful consideration. Origin considers it reasonable on face value to evaluate whether a criterion aimed at assessing a pipeline owner's market power in the provision of capacity into the coverage criteria and expand the scope of reference services. However, we consider further regulation should only be introduced where there is a clear market failure and consideration should also be given to the cost of additional regulation and the potential for this regulation to impact pipeline owner decision-making and negotiation processes with shippers would need to be assessed.

Prohibit contractual provisions in GTAs which limit capacity trading by shippers

This mechanism would prohibit the following contractual provisions that the AEMC suggests may confer market power to pipeline owners:

- nomination cut-off times that favour capacity sales by pipeline owners compared to sales by shippers that hold capacity;
- restrictions on a shipper's ability to change receipt and delivery points (or to move MDQ and MHQ between points);
- the requirement to negotiate allocation agreements at deliver/receipt points; and
- other fees and charges levied by pipeline owners that limit capacity trading.

The AEMC suggests removing these provisions may increase the value of the capacity product to prospective shippers, increasing the demand for the product, and hence facilitating trade. Origin supports investigating whether these provisions could be removed. However, these investigations would need to assess any practical implications; for example, nomination cut-off times and restrictions on the ability to change receipt and delivery points are often based on technical requirements of the pipeline.

Should you have any questions or wish to discuss this information further, please contact Lillian Patterson on lillian.patterson@originenergy.com.au or (02) 9503 5375.

Yours sincerely,

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