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Ms Shari Boyd
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Project reference code: GRC0029

Dear Ms Boyd

APA Group (APA) welcomes the opportunity to comment on the Australian Energy Market Operator (AEMO) draft determination in respect of the Rules for allocating Authorised MDQ and AMDQ Credit Certificates.

APA supports the non-controversial aspects of the Rule change being made; these have the scope to add some marginal clarity to the operation of the Rules.

The draft determination correctly acknowledges that the AEMC's proposed reforms to the Declared Wholesale Gas Market would involve a change to an entry-exit system for allocating pipeline capacity. Under this model, AMDQ Credit Certificates would no longer have a role to play. Particularly given the inclusion of AMDQ Credit Certificates as a Reference Service in the AER-approved access arrangement, APA agrees with the AEMC that the implementation and administrative costs associated with the draft preferred rule would outweigh any potential benefits associated with it.

Considering the scope of reforms to the DWGM proposed by the AEMC, APA recommends that either no Rule change be made at this time, or that the AEMO proposed Rule change, clarifying existing arrangements, be made.

However, should the AEMC decide to proceed with its preferred Rule change, APA believes that the draft determination exhibits a critical misunderstanding of the role AMDQ Credit Certificates play in supporting system investment, the interoperation of these with the requirements of Rule 79, and the consequential signals for network investment.

The draft determination also does not reflect the AER's determination that AMDQ Credit Certificates are a Reference Service under the prevailing Access Arrangement, for which a Reference Tariff has been established. Under this framework, any benefits to be obtained through the proposed Rule change are severely curtailed.

APA does not support the controversial aspects of the preferred Rule Change proposed in the draft determination.

APA discusses these issues in the attached submission.

If you would like any further information, please call Scott Young on 02 9275 0031 or scott.young@apa.com.au.

Yours sincerely

Peter Bolding

General Manager Strategy & Regulatory

National Gas Amendment (DWGM-AMDQ Allocation) Rule 2015

APA submission responding to Draft Rule Determination

1. Introduction

APA Group (**APA**) welcomes the opportunity to comment on the Australian Energy Market Operator (**AEMO**) Rule change request in respect of the Rules for allocating authorised MDQ and AMDQ credit certificates (collectively, **AMDQ**).

APA does not believe that the AEMC has correctly interpreted the current operation of the Rules, and as a result, has concluded that the AEMO-proposed Rule change substantially changes the allocation process for AMDQ, and associated investment incentives. This is not the case.

APA supports the Rule change as lodged by AEMO in November 2013 as providing for improved clarification of the operation of the current rules for the allocation of AMDQ, as well and appropriate signals for timely investment in new capacity on injection pipelines.

APA wishes to advise that, effective 4 December 2015, the name of the entity previously known as "APA GasNet Australia (Operations) Pty Limited" (ACN 083 009 278), the Service Provider under the Declared Transmission System Access Arrangement, has been changed to "APA VTS Australia (Operations) Pty Limited" (**APA VTS**).

2. A Rule change is not appropriate at this time

Question 1 Impact of the Review of the Victorian DWGM

(a) Given the draft recommendations set out in the Review of the Victorian DWGM, what is the view of stakeholders in relation to whether the NGO would be best promoted by implementing the aspects of the draft rule that relate to which party should be responsible for allocating AMDQcc?

(b) Should the Commission consider an alternative approach?

(c) Alternatively, are stakeholders of the view that no rule should be made? If yes, why?

APA VTS is of the view that it is not appropriate to make the proposed Rule change at this time, on two grounds:

- The APA VTS Access Arrangement includes AMDQcc as a Reference Service with a Reference Tariff; and
- As identified by the AEMC, the reforms to the DWGM contemplated by the AEMC would mean that any benefits associated with this Rule change would have a relatively short time to be realised and recover the costs of implementation.

AMDQcc as a Reference Service

The Draft Rule determination appears to be concerned with APA VTS earning revenue in excess of the allowed regulatory revenue through the allocation of existing AMDQ.

This is no longer possible in the context of the current AA, in which the AER has determined that AMDQcc are a Reference Service[1] and for which the AER has established a Reference Tariff ($0.00125/GJ)[2]. At this low reference tariff, there is little scope indeed to deliver significant benefits to the market by changing the allocation process.

This means that the benefits accruing from the AEMC's preferred Rule are significantly curtailed - there is no longer a financial driver for the preferred Rule change to deliver benefits to users. However, there are added complications (and therefore costs) for AEMO in both administering the process and incorporating the highly uncertain financial flows into its budgeting processes.

The AEMC's proposed reforms to the DWGM

On p6 of the draft Rule Determination (and in a number of other places) the AEMC expresses a concern that the proposed Rule may not have a sufficiently long operational life for the benefits to recover the implementation costs:

> Although the Commission considers the more preferable draft rule, in relation to the allocation process is in the long term interests of consumers, the Commission has made a number of recommendations in the draft report in the Review of the Victorian Declared Wholesale Gas Market that, if implemented, would make the Commission's more preferable draft rule redundant. Therefore, the implementation and administration costs associated with this aspect of the more preferable draft rule may outweigh the short-term benefits, if the Commission's recommendations in the review are adopted. [AEMC p6]

Considering the low scope of benefits to be realised under the preferred rule change as discussed above, APA VTS considers that it would take many years indeed for the AEMC's perceived benefits of the preferred Rule to outweigh the expected implementation and administration costs.

APA VTS agrees with the AEMC that it is not at all clear that this change will have a long enough life to achieve a positive cost/benefit result in light of the AEMC proposed recommendations to convert the VTS to an entry-exit model.

For clarity, as discussed more fully below, APA VTS does not support the AEMC's preferred Rule change.

In light of this uncertainty, and in the interest of limiting the amount of reform fatigue, it would be sensible to not make a Rule at all at this time. That is, APA VTS submits that it would be reasonable to decline to make a Rule at this time, and allow a market participant to reinvigorate it in the event that the entry-exit model does not proceed (and there appears to remain a need for it).

3. Should the AEMC consider it appropriate to proceed with a Rule change

Question 2 AEMO's allocation process

(a) Are stakeholders of the view that it would be beneficial for any final rule to provide a set of guiding principles to be taken into account as part of AEMO's auction design?

(b) Are stakeholders of the view that the same, or a different auction design, as the one used for authorised MDQ should be implemented by AEMO for AMDQcc?

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[1] AER, *APA GasNet Australia (Operations) Pty Ltd Access Arrangement Effective 1 July 2013 to 31 December 2017*, April 2013, s2.2.

[2] AER, *APA GasNet Australia (Operations) Pty Ltd Access Arrangement Effective 1 July 2013 to 31 December 2017*, April 2013, Schedule 1.2(f).

APA VTS considers that, to the extent that guiding principles for AMDQ cc auctions depart from an open auction, i.e., with no limits on price, they will blunt any pricing signals generated.

AEMO currently auctions Authorised MDQ using an unconstrained price auction. However, these auctions take place infrequently and generally for quite small volumes; -in this context any market impacts caused by an unconstrained price auction may be minimal. However, any auctions of AMDQ cc will likely be for large volumes (reflecting the "lumpiness" of investment) on a more regular basis.

However, the current APA VTS AA is silent as to any method of allocation of AMDQ cc. Without a price signal to constrain demand, there is considerable scope for oversubscription of this (nearly) free good. This would suggest that AMDQcc should be allocated on the basis of an expression of interest with a pro-rating mechanism if more is requested than is available. The design of the mechanism would need to take account of the subscribers' potential behaviour to game the process.

However, it is unlikely that AMDQ cc would ever be made available at the Reference Tariff, as the revenue stream would be insufficient to justify the investment that would create the AMDQ cc. This is discussed in more detail below.

Underwriting injection capacity in the VTS

As explained below, APA VTS is firmly of the view that the allocation of AMDQ cc combined with contractual take or pay requirements is critical to underwriting injection capacity in the VTS. Both these features must rest with the Service Provider in order for the relationship to be effective.

No "prepayment" of transmission charges

The draft rule determination incorporates a basic misunderstanding of the mechanics of payment to APA VTS for AMDQ cc. Importantly, there is no "pre-payment of transmission services" - under the current AMDQ cc contracts, contract payments replace the injection charges up to the contract quantities.

Payment of AMDQ cc follows the same timing as payment of injection charges, i.e., the annual charges are levied monthly throughout the year based on the expected peak injection volumes or, in the case of AMDQ cc, the contracted injection (AMDQ cc) volumes. The monthly charging methodology has been standard and defined in APA VTS's AA since the system was initiated in 1999. There are no upfront payments for AMDQ cc, either on initial allocation or annually.

In short, the allocation of AMDQ cc results in a future take or pay obligation, not a prepayment at the time of the AMDQ cc allocation.

Furthermore, while the Draft Rule change notes that APA VTS is not precluded by the NGL/NGR from earning extra revenue in addition to its regulated revenue, it also makes the point that the draft rule will further limit the APA VTS's opportunities to do so. It appears that there is an understanding by the AEMC that the APA VTS has an opportunity to earn significant sums in this manner. This is not the case – as discussed above, the decision of the AER in the current AA for the APA VTS to make the provision of AMDQ cc into a reference service precludes this opportunity. Any Market Participant can now request access to any available AMDQ cc and will pay only the regulated tariff which is set at a nominal level. In any event, the opportunity to do so prior to the AER making AMDQ cc a reference service was limited and acted as a balance between AMDQ cc acting as an investment signal and a constraint on market participants from seeking a greater than optimal allocation of AMDQ cc.

Under a market regime in which participants bid for AMDQ cc on a "take-or-pay" basis, the AEMC appears to be concerned that APA VTS could earn "extra" revenue (compared to a system without AMDQ cc) to the extent that AMDQ cc was allocated (contracted) but not used.[3] The costs associated with unused allocated AMDQ cc acts as a deterrent to market participants from over investing in such allocations.

Given the commercial discipline on market participants over investing in AMDQ cc allocation, the extent to which the market participants as a whole bid for AMDQ cc, with its "take-or-pay" obligation, provides a strong signal as to how much AMDQ cc is required, and thus whether further investment is required to increase the amount available. This dynamic has been destroyed by the decision of the AER to define AMDQ cc as a Reference Service with only a nominal tariff.

The take or pay component is critical to determining the future revenue stream resulting from the investment. In the absence of a take or pay provision, APA VTS would have no certainty as to the amount of the injection capacity that would be nominated in any particular day, and therefore no confidence on the future revenue stream.

This take or pay obligation is critical to the "economic value" analysis required to justify new investment under Rule 79 as discussed below.

Operation of Rule 79

In order for a system expansion investment to qualify as conforming capital expenditure for inclusion in the capital base, the overall economic value of the capital expenditure must be positive:

> 79 New capital expenditure criteria
>
> (1) Conforming capital expenditure is capital expenditure that conforms with the following criteria:
>
> (a) the capital expenditure must be such as would be incurred by a prudent service provider acting efficiently, in accordance with accepted good industry practice, to achieve the lowest sustainable cost of providing services;
>
> (b) the capital expenditure must be justifiable on a ground stated in subrule (2).
>
> (2) Capital expenditure is justifiable if:
>
> (a) the overall economic value of the expenditure is positive; or
>
> (b) the present value of the expected incremental revenue to be generated as a result of the expenditure exceeds the present value of the capital expenditure ...

The present value calculation undertaken to satisfy the Rule 79 "positive economic value" test is generally conducted over the life of the asset.

In order to clear the hurdles of Rule 79(2)(a) and (b), APA VTS needs to have confidence in the future revenue stream to be generated from an expansion of a given size (and cost).

[3] It has been claimed additionally that if another market participant (without an allocation of AMDQ cc) used the pipeline capacity not used by the AMDQ cc holder, then that would also be extra revenue. However, that revenue would have been earned by APA VTS (by delivering the shipper's gas) and so is not "extra" revenue.

Where there is no commitment on the part of the project proponent, APA VTS must rely on an uncertain forecast of usage of the new injection capacity. This forecast must be found to be reasonable by the AER in its assessment of whether the investment clears the Rule 79 hurdles.

As there is no requirement for a shipper to commit to injecting gas at a particular injection point, this forecast will necessarily be risk-adjusted and therefore conservative, particularly in the case of larger participants who may have a range of injection points to choose from.

This will mean that the forecast revenue stream feeding into the present value calculation will inevitably be lower, which means that the level of conforming capital expenditure that can be supported will be lower. The result of this is that a smaller (than required) expansion will be able to be built and the system will be chronically undersized.

An example may be useful to illustrate this point. Assume that a shipper had a new load (say, for a new food processing facility) with a winter peak demand of 10 TJ/day for the three peak agricultural harvest months of the year, but an average demand over the balance of the year of only 3 TJ/day. The shipper requires the transmission system operator to build an expansion that will serve the 10 TJ/day peak demand. With an AMDQ take-or-pay provision, APA VTS has sufficient certainty on the revenue stream to be able to justify a 10 TJ/day expansion in the context of Rule 79. Without the take-or-pay certainty, APA VTS would only be able to forecast revenues associated with the average load of 4.75 TJ day (10 TJ/day over 3 months and 3 TJ/day over 9 months). APA VTS would only be able to forecast a revenue stream sufficient to justify an expansion to serve 4.75 TJ/day – clearly insufficient to meet the shipper's peak demand needs.

With AMDQ cc as a "take or pay" service, APA VTS has much greater confidence in the revenue stream that will be produced by a particular expansion, and that revenue stream will support a more efficiently sized expansion reflective of the market's stated needs.

Restrictions on the term of AMDQ cc contracts

However, a restriction on the term of AMDQ cc contracts equally serves to undermine the revenue stream and reduce the present value of forecast cash flows. This inevitably results in the revenue stream supporting a smaller expansion under Rule 79.

The proposed preferred Rule indicates that APA VTS should be allowed to allocate AMDQ cc only in the circumstance where an expansion is not included in the forecast capital expenditure for the AA, and only then until the expansion capex is included in the regulated capital base. This curtails the term of the AMDQ cc contract to a maximum of five years.

In APA VTS' experience, shippers seeking expansions of the pipeline seek to be able to use that additional capacity in the long term. A curtailment of the term of AMDQ cc contracts (even with the "take or pay" featured retained) creates an imbalance between a short term commitment by a shipper (as its commitment would fall away at the next AA), and a long term commitment by the pipeliner and the rest of the market (to carry the costs of the pipeline expansion in the long term).

Moreover, this curtailment of term would restrict the revenue stream feeding into the Rule 79 present value calculation, again resulting in suboptimally sized expansion being undertaken.

Referring back to the example above, the unit cost of AMDQ cc would need to be considerably greater if its revenue contribution can only be applied for a short term of the Rule 79 long term NPV calculation.

It is important, then, for the AMDQ cc contract (including the "take or pay" feature) to be able to have an extended term, both for the shipper to signal its long term commitment to the capacity expansion, and to give certainty to the revenue stream to support the optimally sized expansion under Rule 79. This cannot be accomplished under the proposed preferred Rule.

Investment signals

On de-linking the allocation of AMDQ from the take or pay obligation, the AEMC comments [AEMC p30]:

> In circumstances where AEMO undertakes the allocation process for AMDQcc, there would be no requirement to bundle AMDQcc with the pre-payment of the reference tariff for transportation services. A holder of AMDQcc would not be required to pre-pay the reference tariff in order to obtain the market benefits associated with AMDQcc. Therefore, they would only be required to pay the reference tariff on the amount of gas they actually shipped. This provides an opportunity for market participants (and by consequence, consumers) to only pay for the transportation services they actually use rather than the amount associated with the quantity of AMDQcc they hold.
>
> That being said, there is nothing preventing APA and a market participant from negotiating and entering into a contract for the pre-payment of the reference tariff for transportation services. This contract would not, where AEMO is responsible for undertaking the allocation of AMDQcc, also provide the market participant with AMDQcc and its associated market benefits.
>
> In these situations the market participant would be able to make a decision regarding the quantity of AMDQcc they may want to hold separate and apart from the question of the amount of transportation services they may wish to pre-pay for.

The AEMC's continued reference to the non-existent "prepayment" problem makes discussion of this section difficult. As explained above, AMDQ cc contracts on APA VTS involve monthly payments over each year relating to the contracted AMDQ cc for that year. As stated above, there is no upfront payment at the time of the auction or for each year of the contract term.

As discussed above, the purpose of the take or pay provision in AMDQ cc allocation is to provide revenue certainty to justify capacity expansion under Rule 79. Separating the decisions of actual injections and the market benefits of AMDQ cc (ie, requiring shippers to only purchase as much AMDQ cc as required to ensure dispatch for a particular day) will undermine the revenue certainty and negate the investment signal. As discussed above, this introduces scope for chronic under-sizing of the system.

Moreover, as discussed above, the pricing structure imposed by the AER with the definition of AMDQ cc as a Reference Service means that any investment signal has been muted. There is no constraint on market participants with regard to how much AMDQ cc they seek. The tariff applicable if they are successful is so small that it generates no incentive to be realistic in deciding how much to seek, and insufficient revenue to serve as an investment signal.

Under the AEMC's proposed preferred Rule, the investment signal for APA VTS would be destroyed. There may be a signal associated with the auction of AMDQ cc by AEMO, however as discussed above, the perverse bidding behaviour likely to occur without a price discipline is likely to render this signal ineffective. Moreover, there appears to be no requirement for AEMO to share this information, and a strong supposition that bidders will regard it as confidential.

In the context of a shipper entering into a bilateral agreement with APA VTS to underwrite an expansion, the AEMC has long acknowledged the "free rider" problem in the DWGM.[4] In a nutshell, a shipper will be reluctant to underwrite investment unless it can be assured access to the capacity underwritten.

In the DWGM, a shipper who invests in capacity cannot be assured access to the capacity, regardless of bidding behaviour. AMDQcc gives the shipper some confidence that it can access capacity underwritten.

Severing the relationship between a take or pay provision and the allocation of AMDQcc rights crystallises the free rider problem – the shipper commits to paying for the capacity (so the investment can proceed), but has no rights to it whatsoever.

As discussed in the APA submission to the discussion paper, this increases the risk of injection capacity investment being chronically (and inefficiently) undersized, or simply not proceeding.

Under the DWGM, the only current mechanism for the service provider to gain confidence on intended flows and revenues, and for a shipper to ensure access to capacity that it underwrites, is through the allocation of AMDQcc by the service provider and a take or pay commitment by the shipper. This certainty is not provided through the allocation of Authorised MDQ or AMDQ cc by AEMO.

As APA VTS advised in the response to the discussion paper:

> These shipper commitments allowed APA GasNet to accurately forecast the demand for the expansion, but also gain certainty over the tariffing arrangements as the agreement with shippers in relation to AMDQcc created a take or pay arrangement for the service. This certainty of demand is critical under the VTS as shippers do not need to commit to their demand under the market-carriage framework. Without the commitment to AMDQcc by shippers, APA GasNet would not be able to be certain that it would receive a return on its investment in additional capacity, or even assess whether the expansion was likely to be conforming capital expenditure [under Rule 79].
>
> The shipper commitment to AMDQcc also allowed APA GasNet to commence work on the expansion prior to the regulatory decision, which was important as it was serving pent up demand for the expansion. Linking the method of allocation of AMDQcc to the regulatory decision making process means that the timing of this investment is similarly tied, and capacity will not become available to the market will not proceed until this decision is made.

Furthermore, by specifying that the AMDQ cc auction process occur at the end of each AA period for the following AA period, the draft rule actually makes it impossible to incorporate the results into the APA VTS review submission to the AER. Such a submission is required to be submitted to the AER a year prior to the end of an AA period and takes most of the previous year to be prepared. Any information generated by the AMDQ cc auction process would thus not be available for use until the preparation of the following review submission.

[4] AEMC, *Draft Report, Review of the Victorian Declared Wholesale Gas Market*, 4 December 2015, s2.1.2: "The lack of exclusive rights to use any extension or expansion in the system means that shippers have little incentive to underwrite investments in the pipeline. All shippers would benefit from a capacity expansion, irrespective of whether they funded or not. There is a hence a "free-rider" problem, which means that market-led investment is highly unlikely to eventuate under the current arrangements."

4. Summary

APA VTS submits that it has, in cooperation with AEMO, developed an effective process through the allocation of AMDQ cc that provides investment signals to the service provider and certainty of system access to shippers underwriting capital expenditure.

The Rule change proposed by AEMO simply formalises these effective arrangements.

In contrast, the AEMC's preferred Rule suffers from a number of critical misunderstandings related to the operation of AMDQ cc, in particular the incorrect notion of a "prepayment" of transmission tariffs. As discussed above, the AEMC preferred Rule change would destroy any investment signals in the VTS, and destroy any certainty that shippers have to access the capacity they have underwritten.

In summary:

- APA VTS supports the non-controversial aspects of the proposed Rule change;
- Should the AEMC conclude that a Rule change is required, APA VTS submits that the AEMC's proposed preferred Rule contains fatal errors that will undermine the incentives for investment in the VTS.
- Considering the AEMC recommendations to transition the VTS to an entry-exit system, APA VTS believes that any perceived benefits from the preferred Rule (limited as discussed above) would not have sufficient time to outweigh the costs of implementing the preferred Rule. It is neither necessary nor appropriate to make the AEMC proposed Rule at this time;
- Should the AEMC conclude that a Rule change is required, APA VTS continues to support the original Rule as proposed by AEMO.