CQ Partners

1 June 2015

John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Dear Mr Pierce,

Stage 1, Draft Report - East Coast Wholesale Gas Market and Pipeline Frameworks Review

CQ Partners is an energy consultancy business that specialises in providing energy related advisory services to electricity and gas market participants and large users. We actively participate in the short-term trading market (STTM) on behalf of our clients and have negotiated several significant gas supply agreements and gas transportation agreements across the eastern states of Australia. CQ Partners is well regarded in the energy sector, with the Partners having worked in the sector individually for over 15 years.

We thank the Australian Energy Market Commission (Commission) for publishing the Stage 1 Draft Report on the East Coast Wholesale Gas Market and Pipeline Frameworks Review and take this opportunity to provide our input and commentary for your due consideration.

Before we commence with our specific responses to the Review, we note that the Commission must have regard to the National Gas Objective (NGO) as set out in the National Gas Law. The NGO is clear in its intent that changes to the Gas Rules must duly consider how it impacts the efficient operation and use of the market for the long term interests of consumers.

"The objective of this law is to promote efficient investment in the, and efficient operation and use of, natural gas services ***for the long term interests of consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas.****"*

In our opinion the Review has failed to adequately consider the NGO. The Review has not demonstrated how the suggested recommendations would, if implemented, benefit the long-term interests of consumers. Its recommendations favours the position of the major producers and sellers of gas at the expense of consumers.

The basis for a number of the recommendations are not correct and this false premise has been used to justify changes to the STTM. It seeks to downgrade the well-functioning and successful STTM markets at the Adelaide and Sydney hubs and replace them with largely unsuccessful Wallumbilla style voluntary hubs. The Review seeks to reverse many of the positive gas market reforms of the past five years that have directly benefited consumers of gas and as a result has failed to comply with the NGO.

ADELAIDE | 143/220 Greenhill Road, Eastwood SA 5063 | **P** 61 8 8464 0099 | **F** 61 8 7225 9963 | **E** info@cqpartners.com.au
BRISBANE | Level 21, Central Plaza One, 345 Queen Street, Brisbane QLD 4000 | **P** 61 7 3012 6149 | **F** 61 7 3012 6001 | **E** info@cqpartners.com.au
ACN 132 405 004

We have used the following broad headings to provide our feedback in relation to the Review recommendations and findings:

Input from Active STTM Customers

The AEMC has established an Advisory Group that provides strategic advice and expertise to the Commission over the course of the Review.

The Advisory Group comprises fifteen members, not one of which is an active participant as a customer in the Adelaide or Sydney STTM Hubs. Eight of the fifteen members comprise the major gas producers and suppliers. Only one (Visy) of the members takes part in an STTM market as a customer and they are a very small and largely inactive participant at the Brisbane STTM Hub (noting they have recently registered in the Sydney STTM Hub).

In our experience, the major gas producers and suppliers have not been strong supporters of the STTM as it is not in their best commercial interests to do so. The STTM's enable large gas users to undertake a more active approach in managing their gas requirements at a lower overall cost and within a risk profile that is similar to a retail based contract. It has enabled large gas users to reject "take it or leave it" high priced gas offers from suppliers and pursue alternative and lower cost gas supply arrangements.

CQ Partners operates a 7-day gas management function that purchases gas for multiple large gas users at both the Sydney and Adelaide STTM Hubs. We have procured contractual gas for many east coast gas users and are well regarded in the market for our experience in dealing with contractual and spot market solutions. At no time during the preparation of the Review were we or several of our clients consulted to provide a "customers" viewpoint. Given the need to satisfy the NGO, we would expect that customers would be consulted prior to publishing the Review findings and recommendations.

Benefits of the STTM for Customers

Historically the major gas customers have contracted bilaterally with the major gas retailers. Infrequently they would contract bilaterally with the major gas producers, but generally the "non-retail" gas producers have been reluctant to contract directly with major gas customers. The gas producers had a preference for major gas customers to purchase their gas through the gas retailers. There was a general perception of a major gas producers and suppliers "Gas Club" and the major gas customers were excluded. This market structure led to asymmetry of information and poor price transparency.

The establishment of the STTM's in Adelaide and Sydney have been a huge success for major customers who actively participate in these markets. It has opened up the east coast gas market to major gas customers and given them the ability to more actively manage their gas requirements. In South Australia, Adelaide Brighton has been at the forefront of managing their gas requirements through the utilisation of the gas spot markets. It has achieved significant benefits from actively participating in the STTM. These benefits are far greater than the gas it directly purchases off the STTM as it is able to adopt a portfolio of flexible gas contracts which can be actively managed through the STTM. Without the STTM, Adelaide Brighton would not have been able to put in place its current portfolio of gas supply arrangements.

The STTM's provides large customers with very significant direct and indirect savings. These multi-million dollar savings for customers exceed the costs of operating these markets. The Review is flawed in its assessment of the benefits to customers of the STTM.

Volume of STTM Gas Trading

The Review makes a key statement on page 81 which forms a key pillar in its subsequent arguments:

"As the majority of trades that occur on the STTM are within-participant, the level of trading liquidity between different entities across the three markets is generally low."

This assertion is based on flawed logic and shows a lack of understanding of how the STTM functions on a day-to-day basis. The assertion that the trading of gas is only liquid when traded between parties where the STTM Shipper and the STTM User are different entities is not correct.

Our clients actively trade gas with third parties via the STTM, with some of these trades appearing as direct purchases from a third party but a large proportion of trades will appear on the market as a same entity transaction. This occurs for several reasons:

1) Clients have their own fixed cost haulage contracts with spare capacity. The lowest cost option may be to purchase gas from third parties and haul that gas to Adelaide under the clients existing haulage contract and therefore under their existing STTM Shipper Trading Right. This gas will appear in the STTM as a same entity transaction.

2) Third parties have their own fixed cost haulage contracts with spare capacity. The lowest cost option may be to purchase gas from third parties, have them haul that gas to Adelaide but grant our client a trading right. For administrative purposes the simplest approach for participants who regularly trade gas under this arrangement is to grant the client a standing STTM Shipper Trading Right. This gas will then appear in the STTM as a same entity transaction.

The STTM provides the fundamental mechanisms that facilitate the trading of gas between multiple parties. Due to the existence of sunk cost haulage contracts, the physical transfer of the ownership of the gas may occur outside of the STTM but without the STTM these transactions would not have been undertaken.

The Review has significantly underestimated the volume of gas trading that is being undertaken in the STTM and the benefits to customers from this gas trading. The premise that the level of trading liquidity between different entities across the three markets is generally low is therefore not factual. This is a material error in one of the fundamental arguments of the Review and it invalidates many of the key findings in relation to the functionality and efficiency of the STTM.

Complexity of the STTM

One of the arguments put forward by the Review is that the STTM is complex. We are an active participant in the STTM for multiple clients on a daily basis. It is not an overly complex market and like all markets, prudent participants need to put in place the appropriate operating, risk management frameworks, and the supporting processes. This is a reality of all trading markets and cannot be avoided by prudent parties.

At its core the STTM is not complex. It is a day ahead gas market where nominations are submitted once per day and the market price setting process is run once per day. In comparison the National Electricity Market (NEM) is a far more complex live market where the market price process is run every five minutes and multiple prices are produced for electricity and ancillary services.

The most significant area of discussion since the start of the STTM has been the balancing components of the market design i.e. Deviations, Market Operator Service (MOS) and Settlement Surplus Shortfall primarily at the Adelaide hub. Much of this discussion has been around the cost of what is called Round Robin MOS and its impact on the quantum of the Settlement Surplus Shortfall. Round Robin MOS has occurred because of the physical realities of gas infrastructure at the Adelaide Hub. After investigation and identification of the main causes, changes were made to the physical infrastructure as well as changes to the calculation methodology of Deviations and the Settlement Surplus Shortfall. As of 2015, the Round Robin MOS issue has effectively been eliminated and this has all occurred within the existing regulatory framework of the STTM.

What was previously regarded by customers as one of the most significant risks of participating in the STTM has been removed. These changes were made very recently and we suggest that the positive impact of these changes are only just flowing through to the broader community understanding of the STTM.

Further evidence that the STTM is not a complex market is the growing number of customers who are seeking to participate in the STTM. According to AEMO it currently has sixteen pending STTM registrations. In comparison after over fifteen years of operation, the NEM has five customers who directly participate. Four participants are smelters and the fifth is Adelaide Brighton who only recently became a participant. In only four years the STTM already has many more customer participants than the NEM with many more seeking to participate.

Inability to Manage Risk

On page 90 of the Review it is argued that the Adelaide STTM is more volatile than the most liquid gas trading hub internationally, the Henry Hub. This may be factually correct but this does not directly translate into the position that the STTM is a volatile market that is not manageable by those that participate in it.

As experienced traders our staff have operated in the NEM, the international foreign exchange markets, Australian, European and US debt and swap markets as well as in the STTM. In contrast to other markets, the STTM is not a volatile market. It is a very stable market with very little volatility. To argue the Adelaide Hub of the STTM is a volatile market is incorrect and historical pricing does not support this position.

The volatility in STTM prices has arisen from downward movements in the STTM prices, not upward movements. These downward movements benefit customers i.e. the volatility benefits customers. What creates risk for gas customers is upward movement in gas prices i.e. high priced gas days.

We have undertaken a very simple comparison of Henry Hub gas prices versus Adelaide STTM Hub gas prices. We have calculated the average gas price at each location and then looked at the frequency of the gas price in that location exceeding 150% of the average on a daily basis. At the Henry Hub these high priced gas days have occurred on 14.7% of the gas days. At the Adelaide STTM Hub these high priced gas days have occurred on 0.87% of the days i.e. on 99.1% of the time the gas price was less than 150% of the average gas price. When these high priced gas days did occur the price above the average price was on par at both the Henry Hub ($4.15/GJ increase) and the Adelaide Hub ($4.24/GJ increase). On this simple measure the Henry Hub is more than 16 times more likely to have a high priced gas day than the Adelaide STTM.

In a market where there is little volatility in prices, there is little demand for financial derivative products. Further there are low cost physical methods available to market participants to manage any short-term STTM price risk, which the Review has failed to consider. Our clients actively use these physical methods to reduce STTM price risk.

A key factor that affects the ability of a customer to manage its STTM gas price risk is the structure of long-term gas contracts. Increasingly new long-term gas offers have terms and conditions which are less flexible and set the timing of the gas nomination process. This has the overall effect of making it more difficult for customers to manage their STTM gas price risk.

Better alignment of the timing of gas contract nominations with the STTM nomination timelines would significantly improve the ability of customers to manage STTM price risks. However, it is unlikely this would occur voluntarily (and the trend has been for the reverse) and would likely require regulatory intervention to implement.

STTM Costs

The arguments put forward on STTM costs are fundamentally flawed. The Review has made an incorrect assumption on the volume of STTM gas traded as discussed above. This invalidates the calculation on the $/GJ costs for gas traded on the STTM as outlined on page 95.

The Review ignores the indirect benefits to customers from participating in the STTM. It is estimated the benefits to customers can be up to 50 times the cost of AEMO STTM fees.

Further the $0.08/GJ cost of operating in the STTM is insignificant relative to the other cost components of the whole gas supply chain. It represents significantly less than the annual CPI increases that occurs on most long-term gas contracts. With long-term gas pricing heading towards $8.50/GJ, the STTM charge represents less than 1% of the gas commodity cost. If a gas retailer was to pass through the STTM costs to its retail gas customers the charge would equate to approximately $0.35 per quarter which is less than half the cost of the postage stamp on their quarterly gas bills.

We concur with the general comments that a review should be undertaken to determine if AEMO's STTM operating costs can be reduced. Like all most other parties, we see this as simply good management practice.

We should always be seeking to perform activities more efficiently. This should not be interpreted to mean that the STTM costs are too high and therefore there needs to be a redesign of the market.

Design of the STTM

The Review has omitted to consider the critical element of the STTM. As stated in the NGO, all gas customers are concerned with the *"reliability and security of supply of natural gas"*. The design of the STTM effectively guarantees the supply of gas to all STTM gas users. Where there is a gas supply problem, there are processes in place to seek to address that situation (known as Contingency Gas). Gas customers who are STTM participants can participate in the Contingency Gas Process. Arguably, they have greater control over their security of supply under the STTM than under a standard gas contract. At worst, the security of supply ranks of an STTM gas customer ranks *pari-passu* [1]with the gas retailers.

For all of our gas clients the security of gas supply under the STTM arrangements has been a critical criteria and arguably the most significant potential barrier to entry. With no security of supply our gas clients would not participate in the STTM.

To be effective at managing the security of gas supply, the STTM must be a compulsory market, incorporate all the parties that supply gas into the relevant distribution network. If the STTM was a voluntary market, then there would be no security of supply and no prudent customer could become an active STTM participant.

A voluntary market would render the STTM's irrelevant for the majority of gas customers and would force them back into more traditional contracting arrangements. A voluntary gas balancing market only serves the interests of the major gas producers and suppliers. It would increase gas costs for many major gas customers and, as a result, may result in the closure of some customer operations. This outcome is not consistent with the NGO.

Transparent Pricing

The objective of achieving transparent pricing is repeatedly identified in the Review. Whilst the transparency of gas pricing is important, it should not be at the expense of the absolute gas price paid by consumers.

An underlying theme of the Review is that the STTM does not provide transparent gas pricing. This is incorrect as the STTM pricing is completely transparent. All bids and offers of all participants are publicly available. There is complete transparency of what makes up the STTM prices. The same cannot be said of long-term gas contract pricing.

There is no doubt there is discomfort amongst the major gas producers that the STTM price is not reflective of the price that they want to achieve in their long term gas sales contracts. Their commercial interests are served if the STTM prices reflect LNG netback pricing. Similarly, there would be discomfort amongst the major gas retailers that the STTM price is not reflective of the prices they want to achieve in their retail gas offers to major customers. Many of these offers are "take it or leave it" offers with little negotiation.

In a gas market where there are only a few gas sellers and a perceived scarcity of supply, the only viable alternative for major industrial customers to achieve a more competitive gas price outcome is to either pursue an active gas management approach which includes participating in the STTM or to use the credible threat of moving to an active gas management approach to obtain more competitive contract pricing. It is in the commercial interests of the major gas retailers that the STTM is not a viable alternative source of gas for its customers and that STTM prices reflect LNG netback pricing.

The closer a gas customer is to the Queensland LNG projects the more likely it is that they will be subject to LNG netback pricing minus transportation costs. The further away a customer is located from the Queensland LNG projects, the more influential underlying production costs are in the contract offer. The offer will also be discounted to LNG netback pricing due to increased transportation costs. It is expected that in the long-term the highest priced gas hub in Australia will be at Wallumbilla.

---

[1] Pari passu means raking equally

It is ironic that, contrary to the NGO, the establish gas market suppliers would want to pursue the Wallumbilla Hub as the best and most transparent pricing location for eastern Australian gas supply.

Wallumbilla Hub

To date the Wallumbilla Hub has not been as successful as the Sydney and Adelaide Hubs. Small volumes of gas is being traded at the Wallumbilla Hub and there are very few active participants. There is also very little interest from new customers to join the Wallumbilla Hub in contrast to the STTM. Considerable cost and effort is being put into trying to improve the Wallumbilla Hub, however, it is unlikely that there would be a positive value outcome if a net benefits test was undertaken.

For example we have taken a snapshot of the last 20 days of trading at the Wallumbilla Hub. As at 28 May 2015 there had been no transactions for 15 of the previous 20 trading days. This reflects its design as a voluntary hub. A customer cannot rely on the Wallumbilla Hub as a reliable source of gas supply. In contrast to the STTM, the Wallumbilla Hub provides no security of supply for customers and this runs counter to the National Gas Objective.

Based on a $0.03/GJ Wallumbilla Hub transaction fee, AEMO would have recovered less than $1800 in fees from all trades over the 20 day period. Using on an estimated annual running cost of $650,000 and deducting the estimated fixed fees recouped from the registered participants, for AEMO to recover its Wallumbilla Hub costs over the 20 day period the transaction charge per GJ would have needed to be $0.41c/GJ which is significantly higher than the STTM costs of $0.08/GJ.

There is a high level of transparency on the AEMO budget, costs and revenues for the STTM markets and the Gas Bulletin Board. The same level of transparency does not apply for the Wallumbilla Hub and it may be operating at a significant loss for AEMO. In other words the fees being charged at not currently recouping the costs of running the Wallumbilla Hub.

Greater transparency would assist in determining if there is cross-subsidisation of costs between the STTM's and the Wallumbilla Hub. If the STTM's were not in place would the Wallumbilla Hub be required to meet a greater proportion of the costs of the gas markets function at AEMO? We note that 42% of the STTM budget are AEMO labour costs and a further 32% is depreciation and amortisation.

Further the Review focusses solely on the $/GJ charge for a voluntary market rather than the broader costs on the whole industry of establishing and supporting the Wallumbilla Hub. It was commented at a recent Wallumbilla Hub forum that more money had been spent on the costs of all the participants to attend the half day forum than had been recouped in fees from operating the Wallumbilla Hub in 2015.

The three gas markets that are working very well are the Sydney STTM, Adelaide STTM and the Victorian DWGM. We are very concerned that the general focus of the Review is to change the design of the three markets that are working efficiently to bring them in line with the one market that is not working (the Wallumbilla Hub). We can only assume this strategic direction has originated from the vested interests of gas industry supply participants because gas customers have not been sufficiently consulted as part of the Review process.

Gas Bulletin Board

We note the proposal to establish the Gas Bulletin Board as the one stop shop for all gas market data. We are an active gas market participant and we currently do not use the Gas Bulletin Board for any market information. We access all the necessary information from other established data sources.

The Gas Bulletin Board costs $1.4m per year to operate prior to any of the proposed expansion in its functionality and this cost is recovered from gas industry participants. The cost of this data facility is the equivalent of 13% of the AEMO's cost to run the three separate STTM markets. To put this in the same context as the STTM operating costs, the Gas Bulletin Board costs the equivalent of 1c per GJ versus the 8c per GJ cost of running three actively traded gas markets. The Gas Bulletin Board does not provide any direct benefits to customers unlike the STTM markets.

We fully support gas market data being readily available to all. However, we envisage there could be significant developments costs required to redirect all gas market data to the Gas Bulletin Board. This development cost runs contrary to the focus of the Review on AEMO's costs of operating the STTM. We suggest the Stage 2 Review should consider the costs versus benefits of centralising all gas market data. It should also consider what new data will be made available. There are minimal benefits from republishing/recycling data that is currently publicly available via AEMO.

With the Gas Bulletin Board costs continuing to rise we consider there should be a review of the cost recovery model to ensure that there is a more equitable cost recovery and it is better aligned to user pay principles. All eastern Australia gas market participants should be contributing towards the cost of the Gas Bulletin Board including gas producers, pipeline operators, LNG plants, supply hub participants and not only the shippers of gas. Currently the parties that are shipping gas to the STTM's and the Victorian Gas Market are bearing a high proportion of the cost of the Gas Bulletin Board.

Gas Price Survey

It is proposed to develop a survey based gas price index for short, medium and long-term contracts. The approach would not require the mandatory disclosure of confidential information (i.e. price).

The lack of any mandatory disclosure would make the results of any survey gas price index almost meaningless. Further with very limited number of gas suppliers, the results would be open to manipulation and could not be relied upon.

Timeframe for Response

The Review was published 7 May 2015. The document is 302 pages long and participants have been given 16 working days to provide a response. This is a very short time frame for such a comprehensive document. The short time frame makes it difficult for customers to adequately consider the report, understand its implications and then prepare a satisfactory response. Many large gas customers do not have the available resources to be able to respond in such a short timeframe.

The draft recommendations of the Review significantly impact upon large gas customers. However, the vast majority of these gas customers have not been directly contacted to make them aware of the Review or to request their input into the process.

The lack of consultation with many of the large gas customers in preparing the Draft Report, the lack of direct notification to large gas customers of the Draft Report and the short response timeframe only serves to re-enforce the perception that the Review has been captured by the major producers and sellers of gas at the expense of consumers.

Conclusion

In our opinion the Review:

- has not given adequate consideration to the NGO and the interests of consumers.
- does not benefit the long-term interests of consumers.
- is fundamentally flawed in many of the assertions used to justify changes to the STTM.
- seeks to downgrade the well-functioning and successful STTM markets at the Adelaide and Sydney hubs and replace them with the less successful Wallumbilla style voluntary hubs.

The Review reverses many of the positive gas market reforms of the past five years that have directly benefited consumers of gas. Australian consumers of energy are suffering from large increases in their energy costs and gas costs will rise significantly over the next few years. The recommendations of the Review will add further to these gas cost increases through reducing the ability of large gas customers to actively manage their gas purchasing arrangements through the STTM. These changes have the potential to result in plant closures and job losses.

World Forum on Energy Regulation

We highlight your very recent excellent speech to the World Forum on Energy Regulation. In your speech it was stated:

> *"Flexible, responsive markets are characterised by market participants that have the information, tools and exposure to price signals which enable them to adjust. So that **consumers**, rather than regulators, are in a position to decide if the value to them of what they are being offered is greater than the costs to the system of providing it."*

We concur with your comments. We restate the discussion earlier in this letter that consumers of gas are saying very clearly that the value of the STTM's is far greater than the costs of providing these markets. This is supported by the number of customers who have already entered or are evaluating entering the STTM's.

Later in the speech it was stated:

> *"The energy regulator's role then becomes to do no more than necessary to support the **participation of individual consumers** in energy markets."*

The design of the STTM's facilitate the entry of customers into the market. The STTM's are not complex, they are a low cost market and there are no significant barriers to entry for customers. Customers have been making significant savings from more actively managing their gas supply arrangements of which access to the STTM's is an integral component.

For consumers of gas the STTM's tick all the boxes of the NGO. They are in the long term interests of consumers, particularly with regard to price, reliability and security of supply.

We thank you for considering CQ Partners comments and would be pleased to discuss our comments.

If you have any questions concerning this submission, please do not hesitate to contact Lino Fusco on (08) 8464 0300.

Yours Sincerely,

Reza Evans
Managing Partner
CQ Partners