20 December 2012

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

Submitted online: www.aemc.gov.au

Dear Mr Pierce

GRC0014 – SHORT TERM TRADING MARKET (STTM) DEVIATIONS AND THE SETTLEMENT SURPLUS AND SHORTFALL – CONSULTATION PAPER

Origin Energy Limited (Origin) welcomes the opportunity to comment on the Australian Energy Market Commission's (AEMC's) Consultation Paper in relation to changes to STTM deviations and the settlement surplus and shortfall.

In the current STTM design, there is a disconnect between the prices for deviations and the costs caused by those deviations. Principally, this means that the parties that cause Market Operator Services (MOS) on a gas day are not required to fund it. The misalignment between MOS costs and deviation prices leaves a significant proportion of MOS costs to be recovered through the monthly settlement surplus or shortfall. This settlement surplus or shortfall represents an unknown, and hence, unhedgeable risk for participants.

The overall intent of this Rule change proposal is to strengthen "cost to cause" within the STTM market design. The Rule change will allow the Australian Energy Market Operator (AEMO) to introduce the average cost of MOS into the deviation pricing structure in its STTM Procedures. This will more directly assign MOS costs to those parties that contributed to the MOS requirements on a gas day, rather than using the settlement surplus or shortfall to recover MOS costs at the end of the month. As a result, this should reduce the settlement surplus or shortfall, which in turn, will reduce the associated risk to participants.

Origin strongly supports the principle of the Rule change proposal to strengthen cost to cause in the STTM. We consider the proposed market design change goes a significant way to reduce deviation pricing uncertainty in the STTM. This helps encourage the efficient use of natural gas services, which in turn promotes the National Gas Objective (NGO).

We make further comments on the following issues in the remainder of this submission:

1. inclusion in the National Gas Rules (NGR) of principles AEMO must consider in determining the deviation pricing structure in its STTM Procedures;
2. further changes to improve the efficacy of the proposed market design change; and
3. the need for the AEMC and AEMO to overlap their respective consultations.

1. Principles for determining the deviation pricing structure

The AEMC has found that Rule 462, which contains the graduated deviation parameters, is the only provision in the NGR that governs how deviation charges and payments are calculated. If this Rule were to be deleted as proposed by AEMO, then the NGR would

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not contain any provisions regarding deviation pricing; it would simply provide that deviation payments and charges are to be determined by AEMO for each gas day in accordance with the STTM Procedures.

Given deviation pricing is an important aspect of market design, Origin understands the AEMC's concerns and agrees that the NGR should not be completely silent on this issue. We consider it good practice that the NGR outline the high level policy directions and the Procedures provide the technical specifics to give effect to those policy directions. As such, we consider it appropriate that the NGR provide some guidance on how AEMO is to develop a deviation pricing structure while the STTM Procedures detail how the deviation charges and payments are calculated.

Origin agrees with the AEMC's suggestion to include in the NGR principles that AEMO must have regard to when determining deviation charges and payments under the Procedures. We consider the AEMC's proposed principles provide appropriate guidance and limits for AEMO to develop a deviation pricing structure in line with its proposed market design change.

2. Further changes to improve the efficacy of the proposed market design change

While Origin supports the principle to strengthen cost to cause, we have identified two limiting factors with the proposed market design change that require further consideration and resolution. These factors reduce the effectiveness of the proposed change by distorting pricing signals and incentives and increasing the risks associated with deviations as a result of non-market factors in the STTM. Addressing these factors is a necessary step to improving the overall efficacy of the proposed design change.

a) MOS pricing

MOS is a service to balance net deviations in the market. There are two components to the cost of MOS on a gas day:

1. MOS service payment, which is paid to MOS providers on a pay-as-bid basis; and
2. MOS commodity payment or charge, which values the additional gas that was delivered or stored on the pipeline at the ex ante market price set two days after the gas day (D+2) for which the MOS was allocated.

Origin considers this pricing structure is not truly reflective of market costs and under the proposed market design change, could distort pricing signals and incentives in the market. Continuing to settle the MOS service component at the pay-as-bid price allows participants to gain a net benefit from deviating because the MOS providers supplying the lower price bids in the MOS stack are paid less than the full economic cost of MOS on a gas day.

Under an improved cost to cause framework, it is appropriate that a deviating participant pay the full economic value of the balancing service. As such, the MOS service payment should be valued at the marginal clearing price rather than the pay-as-bid price. This price represents the true and efficient cost of balancing gas on a day. It is also a more equitable outcome as it removes the ability for deviators to benefit from lower priced bids in the MOS stack.

Incorporating an additional amendment to the pricing of the MOS commodity payment or charge would further improve this change. As the proposed MOS service component would represent a daily settlement price, it would be possible to settle the MOS commodity component on a gas day, rather than at the D+2 ex ante market price. Origin suggests that the ex post imbalance price on a gas day is an appropriate basis for pricing the MOS commodity payment or charge.

AEMO's proposed market design change intends improving cost to cause and hence, reduce risk in the STTM. Our proposed change further improves cost to cause by providing stronger pricing signals and incentives. This change also enhances participants' ability to manage risk because a gas day is self-contained and the ability for one gas day to influence following days is reduced as D+2 pricing is removed.

We note that should these changes be adopted, it will be necessary that AEMO introduce the clearing price of MOS into the deviation pricing structure in its STTM Procedures. This would be instead of the average cost of MOS that AEMO currently intends adding to the Procedures. Using the clearing price rather than the average cost of MOS ensures deviators continue to pay the full economic value of MOS.

b) *Deviations as a result of non-market factors*

Through this market design change, AEMO intends to assign the cost of MOS to those parties who caused it on a gas day. This change does not, however, address a scenario where there are large deviations or scheduled MOS that are beyond participants' control and it is unclear who is responsible for those costs. An example of such a scenario is when there is a pipeline capacity data error.

Since the start of the STTM, the market has experienced a number of pipeline capacity data errors that have resulted in high MOS requirements, which in turn have had a significant financial impact on participants. As a result, AEMO and industry have worked together to implement market changes that go some way to reduce the probability of such pipeline data errors occurring. These changes have proved quite effective as there has not been a significant pipeline capacity data error in the past 12 months. The potential for such errors, however, still exists.

While Origin recognises that the likelihood for errors is reduced, the proposed market design change heightens the consequence of significant financial impact as a result of these errors. This is problematic for participants as it is a risk that they cannot manage. Consequently, we consider there is a need for a further change for managing situations where it is not clear who is responsible for MOS costs. This change should be pursued as a matter of priority to ensure the financial impact as a result of an error is minimised.

Specifically, Origin recommends the NGR be amended to introduce an ability to review and resettle price outcomes in the event that there are large deviations or scheduled MOS due to non-market factors. It is simpler to review and resettle price outcomes for a gas day if that day is self-contained. As such, this proposal complements our earlier suggestion in relation to MOS pricing.

Origin understands our two proposed changes widen the scope of AEMO's original proposal but we consider they are necessary to enhance the overall intent of the original proposal. The resultant improvement in pricing certainty for participants further promotes the NGO by enhancing the overall efficiency of the STTM.

3. The AEMC and AEMO's respective consultations

AEMO has explained that the changes to the deviation pricing structure that will give effect to the proposed market design change will be contained in the STTM Procedures. It notes that it requires the requested Rule changes as its proposed Procedure changes are incompatible with several provisions in the NGR. Although the detail around the

Procedure changes will be the subject of a separate AEMO consultation process, AEMO requires some certainty that a suitable Rule change is likely to be made before it commences this consultation process. We understand that it intends to commence this process following the publication of the AEMC's Draft Determination.

Origin agrees it is appropriate for AEMO to wait until the publication of the AEMC's Draft Determination before it commences its own Procedure change consultation. We suggest that stakeholders should then also have sufficient opportunity to assess AEMO's Procedure change proposal prior to the close of submissions to the AEMC's Draft Determination. This will allow stakeholders to evaluate the two processes concurrently to ensure the robustness of the overall market design change and then provide feedback to the AEMC's process if necessary.

Overlapping the two consultation processes is particularly important for assessing the AEMC's proposed principles. It will allow stakeholders to assess whether the proposed principles provide sufficient guidance and limits for the development of deviation prices and charges in the STTM Procedures. By doing this, stakeholders can confirm whether there is an appropriate balance of prescription in the NGR around the detail in the Procedures.

4. Further information

Should you have any questions or wish to discuss this information further, please contact Hannah Heath (Manager, Regulatory Policy) on (02) 9503 5500 or hannah.heath@originenergy.com.au.

Yours sincerely,

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