

12 February 2016

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

Dear Mr Pierce

### **APA Group response to AEMC Stage 2 Draft Report (project GPR0003)**

APA Group (APA) appreciates the opportunity provided by the Australian Energy Market Commission (AEMC) to respond to the findings and draft recommendations of the Stage 2 Draft Report prepared as part of the East Coast Wholesale Gas Market and Pipeline Frameworks Review.

APA supports the Council of Australian Governments (COAG) Energy Council vision for a liquid wholesale gas market in eastern Australia, and the efforts being made to structure the gas market so that the vision can be realised.

APA strongly advocates that gas market development is best delivered by market participants, and not by regulatory intervention. Market participants will only be able to make continued investments in pipeline infrastructure that enables market development provided the investment incentives are preserved.

APA has demonstrated its willingness to lead the development of the market for non-discriminatory access to primary and secondary pipeline capacity. APA intends to continue in this leadership role.

To this end APA commits to:

1. Pursue the AEMC's principal innovation advanced in the Stage 2 Draft Report of auctioning contracted but un-nominated capacity where pipeline capacity is fully contracted; APA proposes that the auction reserve price be set at zero;<sup>1</sup>
2. Ensure that there is transparency of all market activity on platforms developed and operated by APA;
3. Ensure that capacity trading platforms are developed and operated in the most efficient manner to minimise cost to the consumer (which APA can best facilitate);
4. Endeavour to have these principles and practices adopted by all owners of pipelines on the East Coast including all owners of LNG supply pipelines; and
5. Further develop Wallumbilla as a northern hub by investing in further capital to increase compression availability.

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<sup>1</sup> The auction platform system costs will be recovered by way of an approved process.

In committing to pursue the AEMC's principal innovation of auctioning contracted but un-nominated capacity, APA commits only to the auctioning of capacity in pipelines which are fully contracted. The auctioning of contracted but un-nominated capacity in pipelines which are not fully contracted is unsustainable because it creates strong incentives for shippers to rely on low-priced capacity from the auction process, and not to reserve firm capacity, thereby undermining financial support for the investment which has been made.

APA's market led approach to the key recommendations of the Stage 2 Draft Report can ensure speed of implementation. Implementation as the AEMC proposes would require legislative change that introduces great uncertainty as to timing.

The success of a market led approach, facilitated by the current regulatory regime, is demonstrated by the build out of gas transmission infrastructure that has occurred over the last decade. APA advocates that regulatory intrusion be kept to a minimum so as not to stifle market response, innovation and investment.

If a deeper and more liquid market is to be achieved, there must also be changes in the market for the commodity. APA is concerned that the focus of the efforts to structure the gas market seems to be on the transportation sector of that market, and not on the market for the commodity itself. APA notes that the development of southern and northern gas hubs, as proposed by the AEMC, are steps in the right direction, but are unlikely to be sufficient of themselves.

APA supports transparency in the primary and secondary markets for pipeline capacity, provided equivalent measures are adopted for primary and secondary gas commodity transactions. It is only in these circumstances where there are equivalent measures applicable to commodity and transport that there can be a meaningful advancement towards the COAG Energy Council's vision. Anything less will be deeply flawed. To this end, APA would support a legislative package that provides for the publishing of the prices of all primary sales of gas and pipeline capacity, and of the terms and conditions of those sales which directly relate to price.

Although APA is committed to pursuing the recommendations of the Stage 2 Draft Report, it has concerns about specific aspects of those recommendations and about the reasoning which supports them. APA's concerns are set out in the submission attached.

APA would be pleased to discuss its response to the Stage 2 Draft Report, and to provide further information which may assist the AEMC in proceeding to its final report. APA's first point of contact is Peter Bolding, on (02) 9693 0053.

Yours sincerely



Ross Gersbach  
Chief Executive Strategy and Development



**Submission to the Australian Energy Market  
Commission**

***East Coast Wholesale Gas Market and Pipeline  
Frameworks Review***

***Stage 2 Draft Report***

12 February 2016



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# 1 Introduction

In this submission, APA Group (APA) responds to the findings and draft recommendations of the Stage 2 Draft Report prepared by Australian Energy Market Commission (AEMC) as part of its East Coast Wholesale Gas Market and Pipeline Frameworks Review.

APA sees the AEMC's Stage 2 Draft Report as making two main recommendations to facilitate future development of the eastern Australian gas market. They are:

- concentration of trading activity at two hubs; these would be a virtual hub in the south based on the existing Victorian Declared Wholesale Gas Market (DWGM), and a physical hub in the north, which would be a further development of the gas supply hub at Wallumbilla; and
- facilitation of access to these two hubs through:
  - implementation of a scheme for the auctioning of contracted but un-nominated capacity on all pipelines;
  - mandatory creation of capacity trading platforms, through which information regarding all capacity trades, including prices, would be published; and
  - publication of the actual prices of all primary capacity sales, and the terms and conditions of those sales which directly relate to price.

In support of these two principal recommendations, the AEMC's Stage 2 Draft Report also makes a series of recommendations to enhance information provision to the market.

APA sees the concentration of trading activity at Wallumbilla, and at a hub based on the DWGM, as building, logically and reasonably, on existing market arrangements. Wallumbilla is a functional point of interconnection in the pipeline network on the east coast, and trading is already taking place in the DWGM.

The principal innovation advanced in the Stage 2 Draft Report is the facilitation of hub access through the implementation of a scheme for the auctioning of contracted but un-nominated pipeline capacity. This scheme is to be given effect through capacity trading platforms which would also provide market participants with information regarding all capacity trades, including the prices at which those trades have taken place.

APA supports the auctioning of contracted but un-nominated capacity, but only on those pipelines where capacity is fully contracted rather than on all pipelines as proposed by the AEMC. It is only on fully contracted pipelines that a mechanism to allocate capacity may be beneficial. On pipelines which are not fully contracted, capacity is readily available from the pipeline operator.

APA has already established platforms on which shippers can offer unused contracted capacity which others can then nominate for the transportation of gas. However, as the AEMC has identified, at nominations cut-off on any gas day, there may remain an amount of contracted capacity which is un-nominated but otherwise available for gas transportation.



APA agrees that making that capacity available, through an auction process, provides a way of facilitating the trading of gas, and of maximising the use of existing transmission pipeline capacity.

APA will undertake the further development of its trading platform to allow the auctioning of contracted but un-nominated capacity on those of its pipelines where capacity is fully contracted, and will publish on that platform information regarding all capacity trades, including prices.

APA is concerned that in focusing on the concentration of trading activity at two hubs, and on the facilitation of pipeline access to those hubs, the Stage 2 Draft Report focuses on the transportation sector of the gas market. The market for gas – for the commodity itself – is ignored.

Hub development, and carefully made changes to transportation arrangements have the potential to lower the costs of market participation and to ensure higher utilisation of existing pipeline capacity, but they are unlikely to bring about a deeper and more liquid market, especially when the price of gas is well above the price of transportation, and the gas price continues to rise.

The AEMC notes that an effective market is one which can deliver a meaningful reference price.<sup>1</sup> The reference price to which the AEMC refers is a reference price for gas established in an integrated east coast gas market. It is more than a price for gas transportation emerging from more flexible and efficient arrangements for access to pipeline capacity.

APA supports transparency in both the primary and secondary markets for pipeline capacity, provided equivalent measures are adopted for primary and secondary gas commodity transactions. Only in these circumstances, where there are equivalent measures applicable to commodity and transport, can there be a meaningful advancement towards the COAG Energy Council's vision. To this end, APA would support a legislative package that provides for the publishing of the prices of all primary sales of gas and pipeline capacity, and of the terms and conditions of those sales which directly relate to price.

APA is concerned that there is still little evidence that pipeline access is an issue. If trading is not taking place, and the Stage 2 Draft Report indicates that that is the case, then the reasons why need to be understood. Shippers may well see significant value in having pipeline capacity “headroom” to deal with contingencies affecting their own plants and operations.

East coast gas market participants may also be increasingly reluctant to trade as LNG export operations ramp up and gas supply into the market “tightens”. Steps – including the auctioning of contracted but un-nominated capacity – might be taken to facilitate access to pipeline capacity but, if gas is in short supply, as now seems to be the case, those steps will not lead to the emergence of a liquid wholesale market.

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<sup>1</sup> AEMC, Stage 2 Draft Report, page 3.



In section 2 of this submission, APA examines and responds to the recommendation to concentrate trading activity at the two hubs.

Section 3 of examines and responds to the proposed auction scheme.

APA's views on the information enhancement recommendations are set out in section 4.

Implementation issues are considered in section 5.

As owner of major pipelines within the Victorian gas transmission system, APA has a strong interest in the AEMC's review of the DWGM, which is being progressed through a contemporaneous and interrelated process.

In this submission, APA examines and responds to recommendations for changes to the DWGM which are made in the context of the concentration of trading activity at two hubs. In a separate submission, APA responds to the AEMC's draft report on its review of the DWGM and, in particular, responds to issues arising in the design of southern hub trading arrangements and the implementation of an entry-exit pricing and allocation model.



## 2 Concentration of trading activity at two hubs

APA supports the Stage 2 Draft Report recommendation for the concentration of trading activity at a southern – Victorian – hub based on the DWGM, and at a second – northern – hub based on Wallumbilla.

The recommendation builds, logically and reasonably, on existing market arrangements. Given the relatively small number of participants in the east coast gas market, and the volumes of gas they transact, the creation of multiple (more than two) hubs, potentially with different designs, risks fragmentation and dilution rather than market integration, and is likely to preclude the emergence of a reference price for gas.

APA examines more closely, and responds to specific aspects of the AEMC's recommendations for the concentration of trading activity, in the following subsections of this section of the submission.

### 2.1 The southern – Victorian – hub

To facilitate the concentration of gas trading activities, the Stage 2 Draft Report recommends the transition of the DWGM into a southern – Victorian – virtual hub in which:

- transportation capacity rights are established for each entry and exit point to the Declared Transmission System; and
- voluntary exchange-based trading replaces the mandatory reverse auction process currently in operation in Victoria.

Transition of the existing market carriage arrangements in Victoria to the contract carriage arrangements found elsewhere in the east coast gas market had been considered but was not accepted by the AEMC because of its views that:

- defining firm point to point transmission rights in the Declared Transmission System would be difficult because the capacity available between any two points was significantly influenced by the expected pattern of injections and withdrawals, and by gas flows across the entire system;
- narrow imbalance tolerances, and associated penalties for breaching the tolerance limits, would require monitoring at substantial cost, and would act as a barrier to the entry of new market participants,
- variability in gas flows was likely to result in greater demand for the high cost services of the Dandenong LNG facility for balancing under contract carriage; and
- the multitude of entry and exit points on the Declared Transmission System meant that the management of gas flows across a virtual hub, by a hub operator, was likely to be more efficient than alternative contract carriage arrangements.



Imbalance tolerances are determined by the physical characteristics of a pipeline system. They are tolerances to which each system user must adhere in the interests of maintaining gas flows to all users. The imposition of these tolerances, and their enforcement should not impose costs on new market participants which are not also borne by incumbents. Imbalance tolerances are not a barrier to entry.

Whether the variability in gas flows is likely to result in greater demand for the services of the Dandenong LNG facility for balancing under contract carriage is difficult to determine. It is, without gas flow modelling under a specific contract carriage alternative, a matter of speculation.

The principal reasons which the AEMC gives for a virtual hub in Victoria, and for further consideration being given to virtual hubs, appear to be the multitude of entry and exit points on the Declared Transmission System, and the increasing interconnectedness of the east coast pipeline system. The more interconnected or “meshed” the pipeline network becomes, the Stage 2 Draft Report contends, the more likely that management of gas flows across a virtual hub, by a hub operator, will be more efficient than alternative contract carriage arrangements. The AEMC provides little in the way of evidence to support the proposition.

Moreover, in comparison to European transmission pipeline systems, neither the pipeline system on Australia’s east coast, nor the Victorian subsystem, are highly interconnected. The Declared Transmission System has long pipelines and relatively few interconnections.

Nor is the east coast pipeline system, which includes the Victorian subsystem, highly interconnected in comparison to pipeline system in North America and, in particular, in comparison to the subsystems in the north east of the United States. The topology of the North American pipeline system clearly demonstrates that virtual hubs are not necessarily associated with meshed pipeline networks. No substantive comparative analysis is presented in the Stage 2 Draft Report which suggests that virtual hubs, and centralised market operation, might be more efficient than decentralised contract carriage arrangements.

To the extent that the Stage 2 Draft Report makes a case for a southern virtual hub, that case rests on the practical difficulties of establishing firm point to point transmission rights, and the allocation of those rights to current participants in the DWGM. These difficulties arise from prior policy decisions in Victoria. They are not relevant for the contract carriage arrangements in operation elsewhere on the east coast. (There is symmetry here: the expropriation of private point to point transmission rights required for the creation of virtual hubs is likely to be resisted by the holders of those rights, making the implementation of virtual hubs elsewhere in Australia practically difficult.)

Details for the design of a southern – Victorian – hub have been set out in the AEMC’s DWGM Review Draft Report, which was published concurrently with the Stage 2 Draft Report. Many aspects of market design, and the way in which existing DWGM arrangements (for example, the rights embedded in rights reflected in AMDQ and AMDQ credit certificates) are to be transitioned, are not yet clear. Although the southern hub proposal seems feasible, uncertainty remains about:

- whether, once more detailed design work has been carried out, it is, in fact, feasible;



- even if it is feasible, whether it is superior to the existing DWGM in terms of its contributing to achievement of a liquid wholesale gas market; and
- whether the costs expected to be incurred by all participants will be outweighed by the perceived benefits.

APA is concerned that the proposed scheme of entry-exit allocation of capacity has been recommended primarily on the basis of similar schemes having been adopted in the United Kingdom and Europe. There are, however, fundamental differences of context between the Australian east coast gas market and the gas markets in the United Kingdom and Europe in which entry-exit allocation schemes have been implemented. Whether these contextual differences will ultimately allow implementation of the proposed entry-exit scheme in Victoria is, in APA's view, still an open question. The analysis reported in the Stage 2 Draft Decision is not sufficient to define the issues and to enable answers to be developed.

The existing virtual market in Victoria was a creation of government. Unlike the Wallumbilla hub, its development was not market driven. To the extent the market will not be used as the basis for allocation of pipeline capacity as is currently the case in the DWGM, it is not clear that the southern – Victorian – hub needs to retain the virtual market design. APA sees that the retention of a virtual hub in Victoria may preclude any evolution of arrangements (for example, a physical hub at Longford) which might better serve the achievement of a liquid wholesale gas market.

APA remains of the view that virtual hub designs suppress property rights in pipeline capacity and remove the foundations on which new investment can be financed. Beyond the particular circumstances of Victoria, the Stage 2 Draft Report makes no case for virtual hubs in Australia.

## 2.2 A northern hub based on Wallumbilla

Wallumbilla is a functional point of interconnection in the pipeline network on the east coast, and its emergence as a hub is being “market driven”. Market participants have seen Wallumbilla as a focal point for trading, and have sought, and have been prepared to support, through the long term contracts for hub services which they have negotiated with APA, the investments in plant and equipment needed to allow gas transfers across the hub.

APA sees the recommendation of the Stage 2 Draft Report to concentrate trading at Wallumbilla as a recommendation for continued development of the gas market in a direction signalled by market participants, and to which they have given their support.

APA supports that continued development.

Indeed, APA is about to further the development of Wallumbilla. As the AEMC has noted, the limited availability of compression service is a constraint on further trading at the hub (see section 2.3 below). Engineering studies have shown that the availability and reliability of compression service can be increased by making relatively minor changes to pipework to establish a new connection between the discharge of the compressors in bank WCS3 and the discharge of compressors in banks WCS1 and WCS2. Detailed design work for the reconfiguration of the pipework is proceeding, and Board approval will soon be sought for an



investment to “unlock” compression capacity and enhance the APA’s ability to provide hub services at Wallumbilla.

AEMO has recommended that the three zones currently at Wallumbilla be consolidated into a single trading zone operating under its proposed Optional Hub Services model. Implementation of the model would be a further logical, incremental development of the hub, which recognises the existing property rights of the market participants whose contracts have supported the investment at Wallumbilla, and which maximises opportunities for others to access hub services.

APA is committed to the implementation of the Optional Hub Services model, and to addressing concerns around access and certainty of delivery. APA is working with AEMO and market participants to further develop the model in the context of evolving market requirements.

The Stage 2 Draft Report advises that a critical weakness in the market design for the Wallumbilla hub is the absence of a mechanism to ensure delivery certainty after a trade has taken place.<sup>2</sup> If a supplier were to fail to deliver an agreed volume of gas, there is no market based balancing mechanism on which the buyer could rely to make up the shortfall. The only remedy that is available to the buyer, in these circumstances, is the payment of compensation by the defaulting supplier. However, compensation may not cover the buyer’s direct costs associated with the default, and its payment cannot ensure the continuity of the buyer’s operations.

In view of this apparent weakness, the AEMC is of the view that, in the future, consideration should be given to a market based balancing mechanism. The implementation of such a mechanism would, the Stage 2 Draft Report advises, require transitioning the northern hub from a physical hub to a virtual hub.<sup>3</sup>

Transition to a virtual hub would, in APA’s view, limit further development of Wallumbilla.

A virtual hub design will not provide the rights to pipeline services which are the foundations on which market participants support the financing of new investment required for hub development. In consequence, investment decision making becomes an administrative process. Decisions to invest in capacity within a virtual hub are made by the hub operator, whose focus is to ensure that gas can flow without imposing excessive congestion costs. The signals for investment are the entry and exit prices of the capacity allocation scheme, and not the long term requirements for capacity to which market participants are prepared to commit. Regulation is then required to enforce recovery of the cost through increased entry and exit prices, and the regulator is typically assigned the role of ensuring that proposed investment within the virtual hub is reasonable. The decision to invest is not “market driven”, with the consequences borne by the individual market participants supporting the investment. It is administrative, and only weakly incorporates a long term view of market requirements. Neither the hub operator nor the regulator has a stake in the outcome, and the cost of any error in their decision making is imposed on all users of the hub, exposing at least some of those users to risks which they would otherwise have avoided.

<sup>2</sup> AEMC, Stage 2 Draft Report, pages 83-84.

<sup>3</sup> AEMC, Stage 2 Draft Report, page 85.



Furthermore, transition to a virtual hub at Wallumbilla would be unnecessary. Were a form of market based balancing to be required – and APA notes that, to date, trade delivery variances have not been an issue at Wallumbilla – there are a number of alternative mechanisms through which it could be provided without the need for a virtual hub. The in-pipe trading mechanism in operation at the hub allocates gas to a buyer, and imposes on the seller the obligation to supply the gas. If that obligation were not to be met, the buyer would be supplied with gas from line pack, and the seller would be obligated to make up the line pack reduction: the current arrangements provide delivery certainty. Alternatively, the balancing mechanism of the STTMs, a mechanism which the AEMC proposes be retained as the scale of those markets is “pared back”, could be implemented at Wallumbilla without the need for a virtual hub.

### 2.3 Competition in the market for hub services

As the Stage 2 Draft Report notes, compression and redirection services are required to move gas across the Wallumbilla hub.<sup>4</sup> In particular, compression service is required to ship gas in a westerly direction, and may be required to transfer gas from the South West Queensland Pipeline into the Queensland Gas Pipeline.

A high proportion of the compression service available at Wallumbilla is currently contracted, long term, to three shippers transporting gas through the hub. These shippers, the AEMC contends, may have limited incentives to offer spare compression service to others seeking to trade across the hub. Shippers requiring compression service may then be forced to purchase higher priced service from the pipeline operator, or may exit the market. Neither of these actions would facilitate trading and the emergence of a more liquid gas market.

The Stage 2 Draft Report proposes implementation of a process for the auctioning of contracted but unused rights to compression service at Wallumbilla, similar to the proposed auctioning of contracted but un-nominated capacity. This auction process for compression service would be implemented on the pipeline operator’s capacity trading platform.

APA could support a secondary market for compression service at Wallumbilla which was based on the auctioning of unused rights to that service. APA’s principal concern about such arrangements would be similar to its concern about the auctioning of contracted but un-nominated capacity on pipelines which were not fully contracted. If there were uncontracted compression service available at Wallumbilla, shippers may use the auction to access that service rather than contract for the service directly from the facility operator, thereby undermining the operator’s ability to finance the investment which must be made to provide compression service.

APA could support a secondary market for compression service at Wallumbilla, based on the auctioning of unused rights to that service, only if all of the compression service available at the hub were fully contracted.

<sup>4</sup> AEMC, Stage 2 Draft Report, page 90.



## 2.4 The Short Term Trading Markets

A form of trading is already taking place in the short term trading markets (STTM) which have been created to facilitate gas supply into Adelaide, Brisbane and Sydney. The Stage 2 Draft Report proposes the “paring back” of the STTMs as the volumes of transactions increase in the southern hub, and in the north at Wallumbilla.

APA agrees that trading markets based on capital cities may continue to provide balancing services which support competition in major retail markets for gas, but the locations of those markets are not points of pipeline interconnection at which significant trading activity might be expected. As the volumes of transactions increase in the southern hub, and in the north at Wallumbilla, the STTMs might be pared back as the AEMC suggests.



### 3 Facilitation of hub access

Three key recommendations made in the Stage 2 Draft Report are intended to facilitate access to pipeline capacity and to increase the volume of trading at hubs. These are:

- auctioning of contracted but un-nominated capacity;
- creation of capacity trading platforms, through which information regarding all capacity trades, including prices, would be published; and
- publication of the actual prices of all primary capacity sales, and the terms and conditions of those sales which might have affected the prices.

APA's gas transportation agreements allow the trading of pipeline capacity but, as the AEMC has observed, the volume of trading taking place is relatively small.

At nominations cut-off on any gas day, there remains contracted capacity which is un-nominated but otherwise available for the gas transportation. APA has sought to make this "unused capacity" available to the market through its provision of "as available" services.

However, as the only seller of capacity beyond the nomination cut-off time, the pipeline operator, the Stage 2 Draft Report contends, has the ability and incentive to price contracted but un-nominated capacity above levels expected in a workably competitive market.<sup>5</sup> High prices for this unused capacity, in combination with shippers' limited incentives to trade, the AEMC concludes, may be resulting in inefficient outcomes which might be addressed by the auctioning of contracted but un-nominated capacity.<sup>6</sup>

APA does not agree that the prices at which it has offered "as available" services are inappropriately high.

The Stage 2 Report goes further, stating that, over the course of the review, the AEMC has identified concerns with outcomes in the market arising from lack of incentives on pipeline owners to offer primary capacity at a price expected in a workably competitive market, and to provide service levels in the secondary market commensurate with what would be expected in a market which was workably competitive.<sup>7</sup> The basis of the AEMC's concerns was, the Stage 2 Draft report noted, advice from a number of shippers (not all shippers on APA pipelines) that, in a workably competitive market, the price of "as available" capacity would be close to short run marginal cost, which was close to zero.

APA responded at length to this issue in its submission on the AEMC's September 2015 Discussion Paper, *Pipeline regulation and capacity trading*. In that response, APA advised that the pricing of effectively firm transportation service provided from unused capacity at less than the firm service price reduced the incentive for shippers to contract for firm capacity

<sup>5</sup> AEMC, Stage 2 Draft Report, page 55.

<sup>6</sup> AEMC, Stage 2 Draft Report, pages 55-56.

<sup>7</sup> AEMC, Stage 2 Draft Report, page 53.



making the continued financing of pipeline assets more difficult and more expensive to the detriment of all shippers.

The AEMC does not agree. Facilitating the release of as-available capacity through daily auctions will not, the Stage 2 Draft report argues, undermine incentives for investment in pipelines due to the very short term nature of the capacity products being offered for sale.<sup>8</sup>

The Stage 2 Draft Report therefore recommends the auctioning of contracted but un-nominated capacity as a further step towards realisation of the AEMC's vision of a liquid wholesale gas market.

Although APA remains of the view that its offer of "as available" service at a price equal to or above the price of firm service was the correct one, APA is prepared to make available, short term, contracted but un-nominated capacity through an auction process. APA would, however, restrict its auctioning of that capacity to those of its pipelines where pipeline capacity is fully contracted.

The auctioning of contracted but un-nominated capacity can, APA maintains, be implemented without the need to extend regulation to pipelines which are uncovered, and without the need for regulator intervention.

### 3.1 Auctioning of contracted but un-nominated capacity

APA understands the AEMC's recommendation for the auctioning of contracted but un-nominated capacity to be:

- capacity which was contracted to a shipper, but which had not been nominated by that shipper, is to be made available for auction as soon as practicable after the nomination cut-off time for that pipeline;
- there is no requirement for the uncontracted capacity in a pipeline to be auctioned;
- the auction is to have a reserve price determined by a methodology approved by the Australian Energy Regulator (AER); the reserve price is intended to allow the pipeline operator to recover any additional costs incurred in making contracted but un-nominated capacity available for auction;
- the pipeline owner is to receive the revenue from the auctioning of capacity (the revenue is not to be transferred back to the shipper which has the contract for the un-nominated capacity); and
- the clearing price and the volume of capacity cleared in the auction are to be published.

The Stage 2 Draft Report raises a number of issues about the design of the recommended auction, but does not address these in detail. It concludes that the auctioning of contracted but un-nominated capacity needs to be subject to regulation under the NGR, and to oversight by the AER.

<sup>8</sup> AEMC, Stage 2 Draft Report, page v.



## 3.2 Auction design

Seven issues arising in auction design are noted, but not addressed in detail, in the Stage 2 Draft Report. These are:

- setting the reserve price;
- determining the amount of capacity to be auctioned;
- auctioning of capacity in pipelines which are not fully contracted;
- design of the allocation process;
- terms and conditions for capacity sold through the auction process;
- the requirements of the access arrangements in place for covered pipelines; and
- pipelines serving single facilities.

The Stage 2 Draft Report advises that, in each case, the issue can be resolved by regulation and oversight by the regulator. APA does not see this as being the case: the recommended auction can be implemented without the burden of regulation.

### 3.2.1 Setting the reserve price

The reserve price, the AEMC suggests, might be set at short run marginal cost in accordance with a formula or mechanism approved by the AER.

The short run marginal cost of transporting gas using auctioned capacity is, however, likely to be close to zero. Many of the costs of pipeline operation, including the costs of scheduled maintenance, and the costs of developing and maintaining the trading platform supporting the auction process, are essentially fixed and will not be recovered through a price based on short run marginal cost.

APA is of the view that the reserve price for the auction of contracted but un-nominated capacity should be zero. The auction platform costs would be recovered via a specific charge set in accordance with an explicit formula.

### 3.2.2 Determining the amount of contracted but un-nominated capacity

A second issue which the AEMC sees as requiring resolution in the design of the auction is the determination of the amount of capacity to be auctioned. This issue arises, the Stage 2 Draft Report advises, because:

- the amount of un-nominated capacity may vary over time, in part with the amount of line pack, or with the timing of planned maintenance; and
- capacity may be withheld to increase the clearing price if the amount is set by the pipeline operator.



To address this issue, the AEMC proposes that the amount be set either by the AER, or by the pipeline operator in accordance with a regulator approved formula or mechanism. If set by the pipeline operator, the NGR might specify the principles on which the AER would approve the formula or mechanism.

APA sees no requirement for any explicit determination of the amount of contracted but un-nominated capacity, and no role for extended regulation or for the economic regulator to be involved in the process.

A shipper's un-nominated capacity is a part of its contracted capacity and, other than in exceptional circumstances specified in the shipper's gas transportation agreement, will not vary over time, with the amount of line pack, or with the timing of planned maintenance.

Under the recommendations of the Stage 2 Draft Report, the details of all primary capacity sales are to be published. APA would also expect to publish daily nominations (as it currently does, for key pipelines, on its capacity trading website) to assist the decision making of all market participants, so that any withholding of capacity by the pipeline operator would be quickly discovered.

In the first instance, the amount of capacity to be auctioned is simply the difference between a shipper's contracted capacity and the total of its nominations on a gas day. This difference should be available from a pipeline operator's gas management system. It represents capacity available at, or upstream of, the delivery point at which there is contracted but un-nominated capacity.

The situation of a buyer requiring capacity downstream of a delivery point at which there is contracted but un-nominated capacity is more complex. The physics of pipeline gas flow is such that less capacity is available downstream of the delivery point. How much less will depend on the physical characteristics of the pipeline, and on daily operating conditions. The operator may, in these circumstances, have to make determinations of the downstream capacity which may be available for auction. These determinations cannot be made using a simple formula which might be codified in the NGR, or which might be made subject to prior approval by a third party such as the AER.

### **3.2.3 Pipelines that are not fully contracted**

The auctioning of contracted but un-nominated capacity in pipelines which are fully contracted appears, to APA, to be feasible.

The auctioning of contracted but un-nominated capacity in pipelines which are not fully contracted is unsustainable because it creates strong incentives for shippers to rely on low-priced capacity from the auction process, and not to reserve firm capacity, thereby undermining financial support for the investment which has been made. If implemented, the auctioning of contracted but un-nominated capacity in pipelines which are not fully contracted will cripple investment. It will crystalize the level of regulatory uncertainty and consequential sovereign risk implicitly involved in undertaking infrastructure investments in Australia.



The auctioning of contracted but un-nominated capacity is not only an efficiency measure, ensuring that any unused capacity is offered to the market on a gas day. It is also measure to discourage the hoarding of pipeline capacity by shippers who have the intention of restricting the access of others to that capacity. However, hoarding cannot be an effective means of restricting access when a pipeline operator can offer uncontracted capacity. The auctioning of contracted but un-nominated capacity in pipelines which are not fully contracted is not needed to discourage hoarding.

If the Stage 2 Draft Report recommendation for the auctioning of contracted but un-nominated capacity is to be implemented, APA is of the view that it should be implemented only on fully contracted pipelines.

But limiting the auction to fully contracted pipelines might, the Stage 2 Draft Report advises, encourage pipeline operators to contract only a proportion (say, 99%) of their capacity in order to avoid the requirement to auction.<sup>9</sup>

APA can see no reason for expecting the operator of an uncovered pipeline to behave in this way. The pipeline operator's financial position is strongest when the capacity of its pipeline is fully contracted. The operator would then have to invest in hardware and systems to support the auction but, as noted earlier in this submission, APA would expect that there would be a mechanism whereby the operator could recover the cost of this investment. Once the auction had been implemented, the operator's costs are likely to be low (recognised in APA's proposal for a reserve price of zero), and the operator retains revenues from the auctioning of contracted but un-nominated capacity.

However, the incentives for the operator of a covered pipeline are likely to be weaker. The AER may consider the auctioning of contracted but un-nominated capacity by the operator of a covered pipeline to be the provision of a rebateable service. The regulator may then require that the operator apply an appropriate portion of the revenue generated from the auction to provide price rebates (or refunds) to shippers using reference services.<sup>10</sup> This rebating of revenues is often contentious, and is, administratively, relatively complex when small amounts of revenue are involved. The regulation of covered pipelines will act as a disincentive to innovation and market development.

### 3.2.4 Terms and conditions

For the auctioning of contracted but un-nominated capacity to be of value to a pipeline operator, the operator will need to ensure that it is useful to a wide range of potential buyers. The potential buyers will, then, play an important role in ensuring that the terms and conditions on which auctioned capacity is made available are not restrictive. Regulatory oversight, as proposed in the Stage 2 Draft Report, will not be required.

Implementation of an auction process will raise design issues such as providing for contingent bidding by buyers seeking capacity across several pipelines. These are essentially technical matters which do not call for, and which would not be assisted by, regulatory oversight.

<sup>9</sup> AEMC, Stage 2 Draft Report, page 61.

<sup>10</sup> NGR, rule 93(3).



### 3.2.5 Covered pipelines

Certainly, arrangements for the auctioning of contracted but un-nominated capacity on a covered pipeline should be consistent with the requirements of any access arrangement in effect for that pipeline.

In this respect, an access arrangement is not different from the contracts for service on an uncovered pipeline. The process for the auctioning of contracted but un-nominated capacity on an uncovered pipeline should be consistent with the requirements of the contracts in place for service provision on that pipeline.

In the process of facilitation of the access to pipeline capacity, especially through the secondary market, APA has made changes to its gas transportation agreements which provide shippers with access to primary pipeline capacity. As secondary market arrangements develop, they will create competitive tensions in both the primary and secondary capacity markets. Those tensions will similarly drive the need for access arrangements – and for regulatory arrangements more generally – to be accommodative of market requirements.

In the short term, the auctioning of contracted but un-nominated capacity on covered pipelines should be consistent with the requirements of the access arrangements for those pipelines. In the longer term, if the AEMC's auction process is to be successful in opening up secondary markets for pipeline capacity, changes will be required in those access arrangements so that they are in accord with the new market conditions.

### 3.2.6 Pipelines serving a single facility

APA agrees that, where a pipeline serves a single facility, there may be little to be gained from implementation of an auction process for contracted but un-nominated capacity.

However, this would not be the case for pipelines serving LNG facilities. The principal pipelines in question may serve single facilities, but those pipelines are interconnected and connect into Wallumbilla. The LNG facilities are, as the Stage 2 Draft Report advises, the principal source of the opportunities for gas trading, and access to the pipelines serving them is essential to development of a liquid wholesale market on the east coast.

## 3.3 Creation of capacity trading platforms

APA has, the Stage 2 Draft Report notes, already established a capacity trading platform.<sup>11</sup> Market participants can use APA's web-based system to find counterparties in a listing of capacity bids and offers, and to engage in over-the-counter trades.

APA sees the development of such platforms as a further step in market evolution.

That step should, APA believes, extend to the provision, on trading platforms, of all information on prices and quantities traded to assist the price discovery process.

<sup>11</sup> AEMC, Stage 2 Draft Report, page 65.



Information about who is trading at those prices is likely to be of use only to those seeking intelligence about competitors. Trading platforms are not intended to assist competitive processes in markets other than the gas market, and APA is of the view that the platforms should not identify individual traders.

The development of capacity trading platforms to facilitate the auctioning of contracted but un-nominated capacity is also a further step in market evolution. Whether that step should be taken now is not clear to APA.

APA's capacity trading platform "opened" in March 2014, when Wallumbilla first began operating as a gas supply hub. APA doubts that sufficient time has elapsed for market participants to explore the trading opportunities available through the existing platform, and for the trading of capacity to become a routine part of market operations.

The AEMC anticipates the further development of capacity trading platforms as requiring the standardisation of pipeline capacity products. In the United States, the Stage 2 Draft Report notes, gas transportation arrangements have been standardised in five broad areas. These are: nominations, balancing, invoicing, capacity release (trading of capacity), and electronic communication.<sup>12</sup>

The standardisation of nominations arrangements is essential to efficient pipeline operation, and APA has already standardised the relevant terms and conditions in agreements which provide shippers with access to primary pipeline capacity for gas transportation on the east coast. Invoicing has similarly been standardised as part of seeking efficiencies in commercial operations. APA has standard interfaces to those of its systems which shippers can access.

Capacity trading is available under the gas transportation agreements which APA has entered into on its covered pipelines, in accordance with the capacity trading provisions of the access arrangements for those pipelines which reflect the requirements of the NGR. Capacity trading is similarly available, and on terms and conditions which are standard, in the gas transportation agreements which APA has entered into on its uncovered pipelines.

APA has sought to standardise aspects of its agreements for access to primary pipeline capacity, but has also negotiated agreements which may appear to be "non-standard". These non-standard agreements have been designed to meet the specific requirements of particular shippers. They recognise a trade-off between efficiency in APA operations, and efficiency in shipper operations. Because these non-standard agreements have been designed to meet the specific requirements of individual shippers, they are not discriminatory.

APA acknowledges that, if both pipeline operators and shippers are to benefit from the auctioning of contracted but un-nominated capacity, the standardisation of transportation arrangements will need to continue. That further standardisation will include standardisation across the transportation arrangements of the multiple pipeline operators serving the east

<sup>12</sup> AEMC, Stage 2 Draft report, pages 68-69.



coast gas market. Non-discriminatory access to capacity (and to hub services) will be, as the Stage 2 Draft Report advises, required for the development of trading liquidity.<sup>13</sup>

The creation of a standard product in the secondary (auction) market may require further standardisation of arrangements in the primary capacity market. However, this should not impair a pipeline operator's ability to provide primary capacity services designed to meet the specific requirements of individual shippers.

APA notes that it has not addressed the standardisation of balancing in the preceding paragraphs. APA has achieved some standardisation of balancing arrangements in its gas transportation agreements, but optimal balancing regimes reflect the physical and operating characteristics of individual pipelines. The technology itself, and the way in which it is used, limit the scope for standardisation. This needs to be recognised in any standardisation of gas transportation arrangements across the pipeline sector.

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<sup>13</sup> AEMC, Stage 2 Draft Report, page v.



## 4 Information and the Bulletin Board

In support of its two principal recommendations (concentration of trading activity on two hubs, and the auctioning of contracted but un-nominated capacity), the Stage 2 Draft Report makes a series of recommendations to enhance the information provision to the market. These information enhancement recommendations are:

- broadening the stated purpose of Natural Gas Services Bulletin Board (Bulletin Board) in the NGR to reflect the wider role that information plays in gas markets;
- expanding the coverage of the Bulletin Board so that a wider range of information is provided through it;
- improving the reporting framework of the NGR to allow relevant facilities to be reported, and in a timely manner;
- strengthening the compliance framework by classifying the obligation to register as a civil penalty provision in the NGL and the NGR;
- harmonising the governance arrangements for Bulletin Board funding with those of other Australian Energy Market Operator (AEMO) functions; and
- maintaining the relevance of the Bulletin Board and other reported information through a regular review process.

APA broadly supports these changes to Bulletin Board arrangements.

Extension of the Bulletin Board reporting requirements to cover all relevant assets in the gas supply chain is, in APA's view, necessary to ensuring that the information provided is complete and useful to market participants. Maintaining the relevance of Bulletin Board information is essential to ensuring the Bulletin Board serves its intended purpose.

The principal driver for change, the Stage 2 Draft Report advises, is the rapid and massive market growth brought about by the production of LNG for export, principally in Queensland. LNG production will provide opportunities for the supply of gas into liquefaction plants. It will also provide opportunities for the supply of large volumes of gas into the domestic market when those liquefaction plants are not operating and the gas from the coal seams which is their primary input must be diverted to other uses.

Information on the prices of gas supplied into the LNG plants, and on the usage and prices for use of pipelines and other infrastructure which are, primarily, part of the LNG supply chain, should, in APA's view, be disclosed via the Bulletin Board to further the process of price discovery.

In its response to the AEMC's Stage 1 Draft Report APA advised that it considered the history of compliance with the rules and procedures governing the Bulletin Board, since 2008, did not warrant changes to the compliance framework. APA continues to hold this view.



The harmonisation of the governance arrangements for Bulletin Board funding with those of other Australian Energy Market Operator (AEMO) functions seems to be to be appropriate.

However, APA remains concerned about the costs which enhanced information provision via the Bulletin Board might impose on pipeline operators. APA does not see the scale of activity by pipeline operators to provide Bulletin Board information as being reduced, and does not see the burden of information provision as being increasingly shared (although a larger number of market participants might be called upon to provide information). APA considers that the cost recovery provisions of the NGR should be modified to better reflect the parties responsible for providing information, and their recovery of the costs.



## 5 Implementation

A staged approach to implementation is proposed in the Stage 2 Draft Report.

Within the next five years, the AEMC anticipates:

- implementation of the recommended enhancements to information provided through the Bulletin Board;
- creation of the governance arrangements required for industry implementation of the recommendations to facilitate access to pipeline capacity, development of the required capacity trading platforms, and implementation of the recommendations to facilitate access; and
- transition of the DWGM to the recommended southern hub design, and complementary development of the proposed entry-exit allocation scheme for the southern hub.<sup>14</sup>

If, within this period of five years, liquidity develops at the southern and northern hubs, the AEMC recommends that the STTMs be pared back so that they support only transparent and competitive balancing.<sup>15</sup>

Although APA does not agree with all of the recommendations of the Stage 2 Draft Report, a period of five years for the implementation of significant changes to market arrangements seems reasonable.

After five years, a review of progress is proposed. This review is to be a review of progress towards the development of a liquid market for pipeline capacity.<sup>16</sup>

To APA, the proposed review seems misdirected. The Stage 2 Draft Report makes a number of recommendations intended to facilitate access to pipeline capacity for the purpose of increasing the volume of trading at hubs, thereby promoting the COAG Energy Council's vision of a liquid wholesale market. Nowhere does the Stage 2 Draft Report consider an objective of developing a liquid market for pipeline capacity.

Nevertheless, if after five years an effective market for pipeline capacity has not developed, the AEMC anticipates that pipeline access arrangement reforms may need to be coupled with a long term use-it-or-lose-it mechanism. Additionally, the AEMC would look to establish a single trading zone in the south east and or the south west of Queensland, and a virtual hub based on that zone.<sup>17</sup>

None of this indicates to APA a coherent view, within the AEMC, of how the east coast gas market might evolve, and of the policy responses likely to be required to assist the process of market evolution.

<sup>14</sup> AEMC, Stage 2 Draft Report, page 105.

<sup>15</sup> AEMC, Stage 2 Draft Report, page 106.

<sup>16</sup> AEMC, Stage 2 Draft Report, Figure 7.1 and page 106.

<sup>17</sup> AEMC, Stage 2 Draft Report, page 106, and also page 41.



What are the pipeline access arrangement reforms to which the AEMC is referring? The changes which the AEMC is proposing to make to access to pipeline capacity are changes to facilitate hub trading. They extend beyond covered pipelines and the access arrangements required for those pipelines. APA understands why this needs to be the case and, in consequence, proposes industry-led changes which will extend to uncovered pipelines.

However, there is still little evidence that pipeline access is an issue. APA makes all of the capacity on its pipelines available to the market every day. Capacity trading is permitted under the gas transportation agreements which APA has entered into on its covered pipelines, and which reflect the capacity trading provisions of the access arrangements for those pipelines and the requirements of the NGR. Capacity trading is similarly permitted under the gas transportation agreements which APA has entered into on its uncovered pipelines. If trading is not taking place, and the Stage 2 Draft Report indicates that that is the case, then the reasons why need to be understood.

The AEMC anticipates further intervention, by creation of a virtual hub in south east or south west Queensland, and the introduction of a long term use-it-or-lose-it mechanism, if the facilitation of pipeline access, coupled with the other recommendations of the Stage 2 Draft Report, fails to increase liquidity in the wholesale gas market. However, there is no reason to expect that these would be appropriate policy responses when little or no consideration has been given to the structure of the market for gas itself, and there is no clear evidence about why shippers are not trading unused capacity when there would seem to be a clear financial incentive for them to do so.