Santos Ltd
ABN 80 007 550 923
Santos Centre
60 Flinders Street
Adelaide South Australia 5000
GPO Box 2455
Adelaide South Australia 5001
Telephone: 61 8 8116 5000
Facsimile: 61 8 8116 5050
www.santos.com

Santos
We have the energy.

23 October 2015

Mr John Pierce
Chairman
Australian Energy Market Commission
Level 6, 201 Elizabeth Street
Sydney NSW 2000

Dear Mr Pierce

GPR0003: Pipeline Regulation and Capacity Trading Discussion Paper

Santos welcomes the opportunity to comment on the Australian Energy Market Commission's (AEMC) Pipeline Regulation and Capacity Trading Discussion Paper. The Eastern Australian transmission pipeline network has grown rapidly to meet the needs of the domestic and international markets for gas, so it is appropriate for the AEMC to review the regulatory framework of today to see if it is compatible with the COAG vision of the gas market for the future.

Santos believes that regulatory or government intervention into the gas markets should only occur when there is a clear market failure. It is with this in mind that we support the AEMC's work into helping articulate the requirements of a functioning liquid wholesale gas market, especially in the capacity trading area. Although we believe that given the chance, the market will be able to design and implement a more efficient capacity trading regime with lower transaction costs than Government. It should be noted that trading of capacity does currently occur between willing buyers and sellers.

The AEMC design work is planning for a future where more short term buyers and sellers will trade available physical (and potential virtual) gas and be able to deliver that gas to their desired destination. This vision is welcomed by Santos, as it would result in a more effective allocation of its resources and enable it and other participants the ability to manage the substantial risks of an upstream and downstream portfolio.

This is however not the current eastern Australia marketplace as there is little demand for short term (day or week ahead) capacity, with current buyers mostly in the market for longer term capacity. There will be opportunities in the future when there is short term gas available and if Santos has capacity available we will utilise this, either via buying gas and transporting ourselves or selling capacity to others. There need be no greater incentive than the ability to recoup a return on long term pipeline capacity investment. The reason that there has been little movement on this to date is lack of demand for this type of product. Without the suitable demand there is little incentive for the industry to spend its finite resources on developing the market place, when there are other priorities at hand.

This AEMC review enables the market to focus on the preferred future market design for all stakeholders as well as identifying who is best placed to progress the improvement areas. Santos believe there is a role for both industry and government to play, although we have a preference for industry led initiatives where possible.

This submission responds to specific areas Santos believes are important for the AEMC to consider when assessing the pipeline regulatory frameworks and capacity trading design options for eastern Australia.

Approach A – Facilitate trading between parties

Santos is supportive of any actions that would assist the facilitation of trading between parties, although believes that this should be industry-driven as it will result in a more efficient and targeted outcome. The approach could include some process or timing oversight from AEMC or other agency - if there was concern that industry would not be able to deliver in a timeframe that was deemed appropriate. It would be prudent to implement these initiatives and analyse the results prior to implementing the more onerous mechanisms outlined in approach B.

Standardisation of capacity rights

Santos is supportive of the development of short term pipeline capacity contracts. It is envisaged that these contracts would largely be used to facilitate secondary market trading of capacity, therefore should be used by both shippers and pipeline owners alike. Further review of specific areas of longer term GTA’s to ensure there is a satisfactory coverage of risk would be required prior to any agreement on the final terms.

These standardised contracts would not replace the need for existing longer term bilateral GTAs, but would help to reduce transaction costs associated with individually negotiated contracts for short term capacity trading.

Pipeline owners offering spare firm capacity

Santos agrees that pipeline owners should have an open process to offer any firm capacity. It is our understanding that this has occurred in the recent past and we support pipeline owners continuing this practise. An auction or similar would enable the capacity to be purchased by those who value it most - ensuring an efficient allocation of resources.

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

Recording short term capacity trades that use a standardised contract is a valuable piece of information that would assist in the development of a liquid secondary trading capacity market. Any on-line or centralised market place where capacity can be traded should publish these trades in real or near to real time. The establishment of this market place should assist those who have an interest in the short term market to congregate. Whilst there may not appear to be demand for this short term capacity trading today, in the future this may facilitate efficient trading.

Santos also believes that short term capacity has different risks, terms and pricing to longer term GTAs. As such, it would not be appropriate to list longer term bilateral transactions on a bulletin board focused on the short term capacity trading markets.

Voluntary surrender of capacity mechanism

Santos believes that the voluntary surrender of capacity to pipeline owners as outlined in the discussion paper would not be of value in the Australian context. There would seem to be little incentive for the pipeline owner to sell excess capacity to another shipper, especially if the existing shipper is already contracted to purchase it and if the pipeline owner is able to contract additional capacity. We believe shippers are in a good position to facilitate the on-sale its own excess capacity. This does not preclude the shipper from offering it back to the pipeline owner if they believe they are in a better position to on-sell.

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

Capacity holders have a natural financial incentive to be able to sell any excess capacity to other market participants who are willing to pay a fair and reasonable price at mutually agreeable terms. Short term capacity trading benefits all market participants, those who have excess capacity on a day are able to recoup some of their investment and those who require capacity are able to bid on and move traded gas to their desired destination.

In Santos' experience there is not an issue with shippers "hoarding" capacity as identified in the discussion paper, rather that capacity is required to underwrite shippers' risk management strategies. Specifically, shippers are required to purchase sufficient contracted capacity to manage their own risks and exposure, which include: requirements for gas retailers to meet either a 1 in ten year peak demand event or to meet the contracted MDQ flexibility in customer GSAs; or for gas fired power generators to ensure they can call capacity when required to meet an increase in NEM demand. As illustrated in these two examples, unutilised capacity does not necessarily correspond to capacity hoarding, but rather effective risk management.

It is also important to note that "Approach B" and the mechanisms explored within is dependent on the wholesale gas market design outcomes outlined in the AEMC's previous discussion paper. The outcomes for this approach in a physical hub compared to a virtual hub differ greatly. However much of what is explored in this discussion paper is based on and referenced to the current eastern Australia wholesale gas market design. Therefore further analysis will be required on each of these mechanisms explored in "Approach B" once the recommended wholesale market designs are established.

Oversell and buyback

The oversell and buy back (**OS&BB**) mechanism as detailed in the discussion paper appears to be a mechanism worthy of further investigation. There do appear to be some significant costs associated with this mechanism, which will require further analysis to ensure that it provides net benefits. However the ability to balance the existing firm shipper's requirements with the objective of full utilisation of existing infrastructure has merit.

Transitional issues will also require further assessment. Santos believes that existing firm shippers should maintain their existing property rights in full. Therefore if there was ever the requirement for a curtailment, the existing firm capacity rights holders should not be affected, rather those parties that participated in the OS&BB to access their capacity would have their capacity curtailed. In becoming a firm shipper on a pipeline, Santos has underwritten the initial investment in the pipeline and this benefit to subsequent shippers should be recognised in transition arrangements.

This OS&BB mechanism is not a quick win, rather something that requires significant review, regulation and oversight. However Santos supports further consideration of the benefits and costs of this as it does appear to help meet the COAG vision while maintaining existing capacity rights.

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

Shippers are required to purchase sufficient capacity to meet contractual requirements, including flex or in the case of gas fired power generators, to anticipate the need for a spike in the electricity demand or shortfall of supply. These conditions are not always easily predictable, so often it is prudent to manage the risk of these events closer to the time. Ultimately this approach will reduce the ability of a Shipper who sells a delivered product to respond to an intra-day nomination from its customer.

Firm day-ahead use-it-or-lose-it removes the ability for the existing shipper to on sell this capacity at the time when they are in a position to more accurately determine their next day firm requirements, resulting in the loss of opportunity and potential revenue.

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

Santos has not experienced a major issue with long term capacity in eastern Australia. Much of the underutilisation of major pipelines is due to the requirement for gas retailers to manage risk limits set by company boards. These risk limits require the ability to supply gas in period when there is a 1 in 10 year peak demand event. This requirement then drives the commodity as well as the pipeline capacity procurement strategies. Any requirement to mandate the removal of capacity may result in security of supply issues effectively making the retailer of gas unable to guarantee supply to its customers if a peak demand event occurs. This could result in significant financial loss to energy providers which would require compensation.

Also as previously mentioned gas fired peaking generation will require access to gas and pipeline capacity to ensure they can maximise their opportunities in the dynamic National Electricity Market (**NEM**). These peaking generators may only be utilized a few times per year, therefore it is essential that they have the ability to call on their capacity when needed. There will be situations where a peaking generator has contracted firm capacity, as it is the only way to guarantee access when required. Long-term use-it-or-lose-it, as per the definition in the discussion paper, would result in the peaking generator losing their capacity, which is not a desirable outcome.

Some of these outcomes are borne from the vanilla nature of the current GTAs. This is due to pipeline owners' general preference for long term contracting to eliminate risk for their investment. There has been little creative structuring that would result in bringing together parties, to share the existing capacity. Achieving an optimal outcome may require further bilateral negotiations and bespoke contracts, as each may have different risk profiles.

Reserve capacity for short term trades

Santos does not support the forced reservation of capacity for the use in short term trading. Reserving capacity for short term trades in isolation, will most likely result in the price of the remaining firm capacity increasing to cover the uncertain return for the pipeline owner. In Santos' experience pipelines owners seek risk free returns for their assets.

Santos supports the short term trading of pipeline capacity and believes that the market will establish the appropriate mechanisms for this when there is the demand for it. It would seem premature to mandate the removal of property rights when there is little evidence that there is sufficient demand for the short term product and before other impediments have been resolved, like those addressed in "Approach A". We suggest that the lack of current demand for short term capacity trading should not necessarily lead directly to the removal of property rights.

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

Santos believes that the contract carriage model has helped transform the current eastern Australian wholesale gas system - helping to deliver on a functioning, interconnected market. However we believe that there is merit in carefully considering the alternatives to ensure that the COAG vision for a liquid and transparent market has the best chance of success. This may require the consideration of the current economic regulation of pipelines if the current regulation is not meeting its intended purpose and it can be shown the benefits outweigh the significant expected costs of a change to a more market carriage model.

Santos also supports access arrangements that result in a fair return for the level of risk taken by the pipeline owner. Other considerations should also be considered including the ensuring all services should be covered as a reference service, not just a selected few. Expanding to all services will ensure that the pipeline owner is able to recoup a fair return for their investment without distortion of the additional uncovered revenue streams. This will ensure a fair outcome for pipeline owners, shippers and consumers alike.

Closing comments

With all of the approaches outlined in the discussion paper, there remains a significant amount of work to convert these identified initiatives into actionable changes to the regulatory framework or market rules. It needs to be acknowledged that some of the approaches may result in a fundamental change to how businesses currently operate as well as how parties who have entered into long term agreements under the existing regime will be transitioned to any new regime. More work and consultation will be required before any clear direction should be set. Ultimately the directions and subsequent outcomes of pipeline capacity trading and regulation are closely interlinked with the outcomes of the previous discussion paper on wholesale gas market designs. As a result it is difficult to definitively comment until these issues are combined in the draft report.

We are supportive of the work currently undertaken by AEMC on this transformation review to date and look forward to working closely to ensure that the roadmap for the future design is clearly defined with actionable and workable steps that will facilitate an effective market.

Should you have any questions in relation to this submission, please contact me at matt.sherwell@santos.com or on (08) 8116 5824.

Yours sincerely

Matt Sherwell

Strategy, Portfolio and Markets Manager
Santos Ltd