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Our Ref: AEMC Pipeline Discussion Paper – EESA Response
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29 March 2016

Mr John Pierce
Chair
Australian Energy Market Commission
PO Box A2449
SYDNEY SOUTH NSW 1235

Dear Mr Pierce,

Re: GPR0003 - Pipeline Access Discussion Paper
East Coast Wholesale Gas Market and Pipeline Frameworks Review

Epic Energy South Australia Pty Ltd (EESA) welcomes the opportunity to provide comments to the Australian Energy Market Commission's Pipeline Access Discussion Paper ("Discussion Paper").

EESA notes that it has worked closely with the Australian Pipeline and Gas Association (APGA) and other transmission pipeline operators in the preparation of the APGA submission to the Discussion Paper and fully endorses the positions contained in that submission. EESA provides comments to the Discussion Paper below to provide further support for an industry led approach in efficiently implementing the initiatives to ensure the Council of Australian Governments (COAG) Energy Councils' objectives of improvements to the wholesale gas markets and pipeline frameworks are met.

Response to Discussion Paper

Implementing the initiatives

EESA considers pipeline operators are appropriately incentivised to implement the recommendations in a timely and efficient manner. An appropriate environment is available to implement the recommendations, specifically:

- The market and Australian Energy Market Commission (AEMC) are signaling the desirability of such an outcome;
- Market demand for gas is forecast to triple with the development of Gladstone LNG export projects bringing with it increased opportunity and risk requiring innovative market solutions;
- Expansion of Short Term Trading Markets (STTM) and Wallumbilla Supply Hub across the east coast gas market; and
- Increased market connectivity delivered by pipeline operators across the east coast gas market.

The environment summarised above has only recently evolved to a point where market change is required and as such there has not been the imperative or market demand for the changes currently been discussed. EESA's view is that an industry-led process has not progressed to date as the market challenges being faced are very current and are continuing to evolve. EESA has been working closely with its shippers to determine the best service structures to meet the significantly changing market requirements in South Australia.

EESA has had little to no shipper demand to align its services with other pipeline operators and sees the APGA proposed industry council structure as being the most efficient path to developing a workable standardisation and increased capacity access solution across all interconnected east coast transmission pipelines.

Standardisation of primary capacity contracts

EESA currently utilises a standard gas transportation agreement (GTA) and is committed to maintaining this as an option for shippers for both primary and secondary capacity contracts. EESA commits to making this standard GTA including pricing available on its public internet site by the end of 2016.

EESA however does not support any recommendation to necessitate the standardisation of primary capacity contracts or to require existing GTA's to be amended to meet standardised terms and conditions.

The negotiation of bespoke GTA's is typically driven by shippers' individual requirements including their proposed utilisation of the services which are determined by the shippers' specific technical requirements, industry and risk profile. As an example, a gas fired generator and an industrial customer that uses a blast furnace within their process, hold varying requirements regarding risk and operational flexibility. Taking this example further:

- The gas fired generator responds to price signals within the National Electricity Market (NEM). The generators' market exposure, the market volatility and their own internal risk management requirements will determine the level of flexibility required and therefore particular service requirements to ensure their ability to appropriately respond to price signals.
- In contrast, the industrial customer that uses a blast furnace in their process may have less exposure to the NEM and more exposure to their individual operational process including the safe and efficient operation of their plant. Typically the industrial customer's demand is driven by market activity for their product however demand may change unexpectedly for operational reasons such as to contain any

cooling of the blast furnace. Where a cooling event occurs it is critical that capacity remains available to ensure sufficient energy can be sourced to protect the blast furnace and ensure continued operations.

In both examples above each customer will require similar services, however the operation of the services will vary. As such pipeline operators frequently develop bespoke agreements to ensure specific customer requirements can be met. The standardisation of primary capacity contracts will limit the ability to achieve these outcomes and potentially drive inefficient operating and risk mitigation costs onto our customers ultimately undermining pipeline investment decisions by customers.

The balance between standardisation and negotiation of bespoke agreements rests with the shippers who must assess the benefits and disadvantages of the alternative approaches. In the example above shippers will assess their specific operational requirements against an ability to easily trade their capacity and determine what their preferred approach will be.

Pipeline operators require the flexibility to negotiate bespoke agreements which match customer requirements to enable customers to manage market and operational risks. The requirement to utilise standardised primary capacity contracts will likely result in reduced incentive for shippers to contract firm capacity where alternatives exist. For example gas fired generators may lose competitiveness against alternate dispatchable energy sources.

Maintaining an ability to negotiate bespoke primary capacity contracts does not restrict the ability to maintain a standardised GTA for the purpose of secondary capacity trading which is discussed later in this paper.

EESA notes that allocation agreement principles are in most cases agreed as part of a capacity agreement. These principles are already standardised and require little action once capacity contracts are entered into either via primary or secondary capacity contracts. In some cases however, specific allocation agreements outside of capacity agreements have been developed but these will continue to be a standardised and as such EESA sees little impediment to expanding these to a broader set of shippers.

Receipt and delivery point flexibility

EESA agrees with the APGA position that pipeline operators be able to reject a change request for both technical reasons and commercial reasons. In addition to the APGA's comments, the addition of new receipt or delivery points may be technically feasible but decrease available capacity due to increased uncertainty of gas flows.

This issue is particularly important for bi-directional pipelines which require a level of certainty regarding gas receipts and deliveries for a particular service. The restriction of delivery and receipt points enable pipelines to model pipeline capacity to ensure cost effective solutions can be delivered to all shippers.

EESA does not object to the inclusion of a time limit regarding response time for the addition of new receipt or delivery points. Any time limit set however must ensure adequate pipeline modelling can be completed to ensure an appropriate decision can be made. EESA notes that pipeline modelling is currently performed by external engineering service providers and any increased frequency in requirement of these services may demand the development of

these skills in-house. EESA estimates that such services performed in-house could cost up to $250,000 per annum.

EESA supports the open access to all receipt and delivery points for secondary capacity contracts on the basis that the service provided under these agreements is at a lower priority to firm under primary capacity contracts.

As mentioned above EESA does not consider changes to allocations agreements to be particularly challenging. Allocation agreements would however need to be established for each receipt and delivery point to ensure the shipper can utilise that point with certainty of outcome in the event of a curtailment of receipt or delivery.

Standardisation of secondary capacity contracts

EESA is committed to maintaining its standard capacity agreement and making this available on its internet site. EESA is also committed to working with an industry led body to standardise the format of capacity agreements and where practicable standardise clauses which will be utilised for secondary capacity trading.

EESA reiterates the APGA view that achieving complete consistency on all matters across pipelines may be technically difficult and may drive unintentional market outcomes. Consideration should be given to each pipelines particular operational requirements. For example, pipelines with a high exposure to gas fired generators typically require an increased focus on hourly delivery rates as a result of the short term nature of the NEM and its volatility in some regions. This focus on hourly delivery rates may not be able to be standardised but there also doesn't appear to be a clear need to standardise this across pipelines that have limited exposure to gas fired generators and volatile electricity prices.

EESA considers the list of operational, prudential and other contractual provisions presented in section 3.2.1 of the Discussion Paper as appropriate when standardising secondary capacity contracts. EESA would consider a range of standards to be more appropriate to allow for varying operational requirements of pipelines.

EESA agrees the operational capacity transfer is an effective means of simplifying capacity trades and should be used for trades conducted through the trading platforms.

EESA agrees with the AEMC's observation that the standardisation of secondary capacity contracts and the utilisation of these for operational capacity transfer obviates the need to standardise primary capacity contracts.

Service and pipeline participation in the auction

Given the intent of the auction is to address contractual congestion and limit perceived market power held by pipelines in the market for day-ahead capacity, EESA agrees with the AEMC's view that these two rationale do not appear to apply in the case of pipelines which are less than fully contracted.

EESA supports a case-by-case exemption of pipelines less than fully contracted. The proposal that the Australian Energy Regulator (AER) assess whether such a pipeline's capacity is being actively marketed for an exemption to be granted is reasonable.

The provision of services in addition to transportation services may be warranted in a proven mature trading platform but an increase in available services from the outset is likely to create further complexity regarding the determination (through pipeline modelling) of available capacity and the selection of the winning bidder. For example, park services will limit the availably of transportation services therefore the publication of available capacity will be subject to the demand for each service.

Where park services are included it should be noted that there may be an impact on the delivery of other services (whether short term or long term). Where gas is parked the subsequent delivery of this parked gas may be restricted due to high demand on pipeline capacity on subsequent days resulting in the gas becoming stranded. In addition, where gas is parked, it has the effect of reducing overall pipeline capacity during a peak demand period due to pressure restrictions. This is likely to limit the appetite of parties to purchase such products through the auction process.

As mentioned within this report EESA does not see it as practicable to sell services on a firm basis, instead services obtained through the auction process should be at a lower priority to firm services provided under primary capacity contracts.

Cost and benefits of proposed auction

Without the detailed design principles of the auction it is difficult to determine the key benefits, risks and costs to business operations. EESA has summarised below some points for consideration:

- Key benefits:

  Increased utilisation of the pipeline and expanded number of shippers leading to the potential for increased revenue. It should be noted however that given the MAPS is not fully contracted, there is presently no barrier to entry for new shippers. EESA consider the benefit to include new shippers which have not previously considered direct pipeline access as an option and have therefore not previously approached EESA for a service.

- Risks:

  Changes in shipper behavior such as reduced incentive to contract firm capacity primarily driven by the standardisation of primary capacity contracts. A reduction in the contracting of firm capacity will likely result in the withdrawal of capacity (through the mothballing of compression assets), in order to effectively manage fixed costs unable to be supported through a higher degree of variable revenue.

- Costs:
  - An increase in receipt and delivery point flexibility or potential for capacity auctions to cause pipeline flow reversal. EESA will be required to develop in-house pipeline modelling capabilities to respond to frequent demand. The development of these capabilities in-house is estimated to cost in the order of $250,000 per annum.
  - Any significant change in shippers behaviors from contracting firm capacity to more interruptible or as available services is likely to cause significant adverse structural changes to the pipeline industry and would have a number of adverse consequences including:
    - Less access to debt capital and higher interest costs. Lenders would be less willing to lend funds over longer periods resulting in reduced access

to debt capital and most likely increased borrowing costs due to the higher risk profile of a pipeliner's revenues. Any increase in lending costs would be passed through to shippers by way of tariff increases.

- Less equity capital available for future investment. As a result of a significant change in risk profile (less firm contracting) there would be less equity capital available for investing in the pipeline industry (which has historically attracted lower risk, longer term capital). Under this change scenario the cost of equity capital would likely be significantly higher than capital currently available for the pipeline industry.

Determining the reserve price

EESA supports proposed auctions be conducted with a reserve price of zero and fuel gas be paid for in kind by shippers. It should be noted that fuel gas is not limited to use in compressors and can also include use in instrumentation and gas heating and cooling equipment. This is a low cost, low intervention solution and avoids the requirement for pipeline operators to engage with the market to source gas.

If pipeline operators were to source gas directly, it would likely require a complicated recovery mechanism, have high transaction and gas costs and will need to be built into the reserve price. This complicated solution will likely be high cost and low reward given shippers will naturally hold gas supply positions already.

EESA expects the calculation of fuel gas to be determined using current industry practice which involves the allocation of actual fuel gas utilised by customers on a day amongst shippers pro rata. Parties acquiring capacity through auction will require sufficient sophistication to manage this and other requirements to provide gas at a later date to manage any imbalances or overruns.

EESA expects the cost of running the auction to be recovered through an appropriate market mechanism. This mechanism has not yet been determined which balances the needs of encouraging active utilisation of the auction system and ensuring pipeline operators are not left out of pocket.

Determining the amount of capacity to be auctioned

EESA considers that the AEMC is correct in its suggestion that determining the amount of capacity to be auctioned is relatively straightforward. As mentioned above the quantity of services made available will impact the calculation of available capacity.

The complexity of determining the amount of auction capacity will be subject to the terms by which auction capacity is offered. For example, if auction capacity is ranked below firm primary capacity and is therefore interruptible this will significantly simplify the determination of capacity available for auction.

Where capacity is supplied through the auction on a firm basis EESA believe this will encourage shippers to take less risk on their nomination on a day meaning an increased risk of shippers nominating higher and adjusting nomination down as market conditions become clearer. It is common practice that downward re-nomination requests are accepted as there are limited technical or commercial reasons to reject such a nomination. The impact of this is

pipeline operators receiving less reliable information in which to utilise for pipeline operational decisions and less capacity becoming available for auction participants.

To ensure an appropriate amount of auction capacity is made available any capacity made available through the auction should be made available on an interruptible basis. The basis by which a pipeline operator can interrupt a shipper who has accessed capacity via the auction process would require standardisation and certainty of outcome. This may be provided by ensuring curtailment rights are well documented within the standardised secondary capacity agreement, for example curtailment may only occur if a re-nomination has been submitted by a shipper with firm rights to do so. Pipeline operators could advise to what extent the amount of auction capacity made available is subject to firm re-nomination rights enabling the purchaser to assess the risk of interruption.

Consideration should be given to bi-directional pipelines where available capacity in a particular direction will be subject to the direction of gas flow under nominations for primary capacity and the outcome of the auction process and resultant net flow direction of the pipeline on a given day.

EESA does not consider an oversell and buyback option to be appropriate as it presents a significant risk to pipeline operators' costs. Where capacity is provided under the auction it will be provided in a period of excess and therefore auction revenue is likely to be low. Where capacity is required, a buy back mechanism will occur during periods of scarcity and therefore the cost is likely to be in excess of the initial revenue. Recovery of this cost will be required with no obvious means to achieve this. It should also be noted that a buy back option may create market participants that speculatively purchase auction capacity with the sole intent of trading it through a period of relative scarcity. The AEMC may need to further consider the impact of shippers accessing capacity through the auction at low or no cost speculatively then not utilising that capacity on the day which again creates uncertainty for pipeline operators.

EESA agrees that determining the amount of capacity to be auctioned will be a relatively simple process (assuming only transportation services are offered). EESA considers interruptible capacity to be the most appropriate service to be provided under the auction with clear definition of interruption rights and an ability for shippers purchasing the capacity through auction processes to assess the relative risk of curtailment.

Interaction between the auction and existing rights

Re-nomination rights available on a pipeline are subject to the particular customers demand requirements. Re-nomination rights may be provided on a firm basis due to the nature of the customer's load requirements which may be a need to manage risk in a volatile NEM or for operational safety requirements, at a blast furnace for example. Where re-nomination rights are required on a firm basis the pipeline operator must have the flexibility to provide this as the risks may range from significant financial loss, lost revenue opportunity to catastrophic plant failure. Specific examples have been provided above when discussing the standardisation of primary capacity contracts.

EESA considers that all capacity acquired through auction should be considered less firm than primary firm capacity. A first price auction settlement should be used to establish the curtailment order, with those parties valuing the capacity least being the first to be curtailed in the event it is necessary.

Retail competition on lateral pipelines

The auction of contracted but un-nominated capacity will likely incentivise shippers to trade capacity prior to the auction where this capacity is available and a customer is seeking access from an alternate supplier. EESA considers retailers and users to be best placed to comment on the significance of this problem and the likelihood of a sufficient remedy.

EESA must highlight however that where capacity exceeds demand on a particular pipeline, firm contracts are required to incentivise pipeline operators to maintain current capacity levels. If the cost of operating a pipeline exceeds the contracted firm revenue, then action must be taken to reduce fixed costs which includes potentially the decommissioning of equipment such as compressor stations and the reduction of pipeline pressures to reduce ongoing maintenance costs. The initiatives mentioned will reduce the available capacity and potentially create scarcity in supply which runs counter to the COAG Energy Council's objectives. The market must be able to issue signals to pipeline operators to ensure the required level of pipeline capacity is maintained. This issue is effectively managed by ensuring the auction process is only relevant to contracted but un-nominated capacity.

Conclusion

EESA is supportive of changes to the pipeline industry that will encourage new entrants and promote increased competition. Such changes however must not come at the expense of irreparably damaging the current operating parameters that have encouraged investments that have led to the connectivity of the east coast pipeline grid, bi-directional services, storage services and other customer driven services.

EESA is confident that an Industry Council as proposed by the APGA will be best placed to deliver on the COAG Energy Council's objectives in a more efficient and timely manner than a more regulatory led approach. The COAG Energy Council's objectives can be met without damaging the current operating parameters by ensuring pipeline operators are able to maintain the flexibility of primary capacity contracts including firm rights within them and standardise secondary capacity contracts to be utilised through an operational capacity transfer on the terms discussed in this paper.

EESA would be pleased to provide further information or discuss any of the points above in more detail should you require.

Yours sincerely

Clive D'Cruz
Chief Executive Officer