PowerWater

Phone 1800 245 092
Web powerwater.com.au

Gas Market Reform Group
c/o Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

By email: enquiries@gmrg.coagenergycouncil.gov.au

Dear Sir/Madam

DAY-AHEAD AUCTION OF CONTRACTED BUT UN-NOMINATED CAPACITY & REPORTING FRAMEWORK – CONSULTATION PAPER – SUBMISSION

Thank you for the opportunity to comment on the Gas Market Reform Group's (**GMRG**) consultation paper (**Consultation Paper**) in relation to the proposed "Day-Ahead Auction of Contracted but Un-nominated Capacity & Reporting Framework" (**Auction**) dated October 2017.

Power and Water Corporation (**PWC**) is a major buyer and supplier of gas and gas transportation services in the Northern Territory (**NT**). The vast majority of the gas that PWC supplies is used by PWC's customers (most relevantly, the NT's major electricity generator, Territory Generation) to generate electricity for consumption by industrial, commercial and residential consumers in the NT. PWC plays a fundamentally important role in ensuring that "the lights stay on" in the NT.

While PWC has been aware for some time of the proposal to introduce an Auction mechanism for gas pipelines on the East Coast, it only recently became aware of the proposal to apply the mechanism to gas pipelines in the Northern Territory (**NT**). As the capacity trading reform package recommended by the Australian Energy Market Commission (**AEMC**), of which the Auction mechanism forms part, was undertaken under cover of the 2016 "Eastern Australian Wholesale Gas Market and Pipelines Review" (**East Coast Review**), PWC had been operating on the assumption that it would not affect pipelines in the NT.

Since becoming aware of the potential application of the Auction mechanism in the NT, PWC has been endeavouring to review the Consultation Paper and participated in a public forum in Melbourne on 31 October 2017. It's aim in doing so has been to ensure that it understands how the proposed Auction mechanism will operate and the effect it may have on PWC's position as the major holder of firm capacity on NT gas transmission pipelines, having regard to the fact that PWC is a Government Owned Corporation and supplies all of the gas used by Territory Generation to generate electricity for consumers in the NT.

For that reason, it would be premature for PWC to express any firm or final views about the desirability of applying the Auction mechanism to NT gas pipelines or its proposed design (as set out in the Consultation Paper). To do that, PWC needs more time and the opportunity to consult with its owner, the NT Government.

At this stage, PWC is only able to offer a number of high level and preliminary comments for the GMRG to consider. They are as follows.

1. **PWC IS GENERALLY SUPPORTIVE OF AN AUCTION MECHANISM AND TRADING PLATFORM**

   Although it has only undertaken a high level review of the Discussion Paper at this stage, PWC is generally supportive of the Auction mechanism and capacity trading platform. The general design appears to be based on economic principles.

2. DEFER APPLICATION IN THE NT WHILE FURTHER DUE DILIGENCE IS UNDERTAKEN

As noted above, the proposal for an Auction mechanism stems from the East Coast Review. As its name suggests, that review principally focussed on wholesale gas markets (and, as part of that, gas pipeline issues) in Queensland, New South Wales, the Australian Capital Territory, Victoria and South Australia.

The East Coast Review did not focus on or closely consider wholesale gas markets, gas transmission markets and electricity markets in the NT, nor the effect of potential reforms on them. PWC understands that is also true of the work that has flowed from the East Coast Review. If the NT markets had been fully considered, then PWC would surely have been involved in the process, given that it is the major buyer and supplier of gas and gas transportation services in the NT.

It is then deeply concerning that there is now a detailed proposal to apply an Auction Mechanism - which was developed to address issues in East Coast gas markets - to NT gas markets. The simple fact is that arrangements in the NT gas industry differ from arrangements on the East Coast gas industry.

While PWC does not propose to explain those differences in detail in this letter,[1] we do draw your attention to the following table, from the Gas Market Report prepared by the Australian Government Bureau of Resources and Energy Economics (November 2014).

Table 1. Characteristics of Australia's gas markets

	Western Australia	Northern Territory	Eastern Gas Market
Mainland Area (sq km)	2 526 786	1 335 742	3 797 333
Population	2 565 600	243 700	20 613 300
Gas production (PJ), 2012-13	1551	26	854
Gas consumption (PJ), 2012-13	516	45	826
Gas exports (PJ), 2012-13	1063	214	0
Major sector users	LNG exports, Electricity generation, Manufacturing,	LNG exports, Electricity generation,	Manufacturing, Electricity generation
Major operating pipelines	7	2	16

[1] PWC would be pleased to provide further information if that would assist. It is enough for present purposes to stress that the GMRG cannot simply assume that the arrangements in the NT are similar to those on the East Coast.

The Table illustrates the:

- significant differences in scale between the NT and other Australian gas markets,
- dependency of the NT on two pipelines, and
- relatively small amount of gas production that is used domestically, which is principally consumed to meet power generation requirements.

This underscores the basic fact that the domestic NT gas market has only 1 producer, 2 pipelines, 1 wholesaler and a few customers, who are predominantly engaged in power generation.

The NT gas market is still in its infancy and new developments in the future, such as a second LNG project and the Northern Gas Pipeline (**NGP**), are part of the evolving process of the development of a competitive gas market. PWC expects that, at some time in the future, it will no longer need to underwrite new pipeline developments in the way it did for the existing 2 transmission lines and the NGP (which is still under construction).

Further, and for example, while nominations on gas pipelines on the East Coast may be relatively stable due to the diversity of consumer demand, that is not the case in the NT. Territory Generation's gas nominations to PWC (which then drive PWC's nominations for transmission services) can vary by more than 20% on any day (and within a day).

In PWC's view, the differences are so significant that it would be imprudent to apply the proposed Auction mechanism without carefully and closely considering how it might actually operate in the NT. Otherwise, there is a real risk that the Auction mechanism will lead to a range of adverse consequences in the NT.

In these circumstances, PWC believes that it is necessary to defer the application of the Auction mechanism to pipelines in the NT until further analysis (or, to put it another way, "due diligence") is undertaken.

3. ISSUES IN RELATION TO APPLICATION TO NT PIPELINES

Based on its review to date, PWC has identified a number of high level concerns in relation to how the Auction mechanism might apply to NT gas pipelines. They can be highlighted by reference to the following scenario.

(a) As noted above, PWC is the major shipper of gas in the NT. It has underwritten, paid for, and continues to pay for all of the costs of, the Amadeus Gas Pipeline and Bonaparte Gas Pipeline (together **AGP**) and is currently the only user of Jemena's proposed NGP.

(b) The AGP was specifically constructed to support the supply of electricity in the NT. It continues to be a fundamental link in the electricity supply chain. Unlike any other state or territory of Australia, the NT is almost entirely dependent upon gas for the generation of electricity to meet the highly variable needs of householders and industry.

(c) There is only one gas project in the NT - the Mereenie gas project - presently transporting small quantities of gas through the AGP. For the foreseeable future, the Mereenie gas project is the only potential user of additional capacity in either the AGP or the NGP. The Mereenie gas project has been offered additional AGP pipeline capacity by both the APA Group and by PWC, while capacity in the NGP is being actively marketed by Jemena.

(d) If the Auction mechanism is applied to the NT, then the Mereenie gas project is highly likely to be the sole participant in the Auction process. At the same time, PWC's contracted but un-nominated capacity, if any on a day, will be the only capacity put up for auction. In this circumstance, the Mereenie gas project would have no motivation to purchase spare capacity from PWC, but would instead be able to secure that capacity - potentially at zero cost - through the Auction process.

There is therefore a real risk that applying the Auction mechanism to the AGP and the NGP will create anti-competitive market distortions. In short, the Mereenie gas project would be able to secure PWC's contracted but un-nominated capacity for free, thereby gaining a cost-advantage over PWC (which will continue to pay all pipeline costs).

It also means the Mereenie gas project would be able to engage in "free riding". PWC has taken significant risk by entering into long term gas transportation agreements (**GTAs**) for firm capacity, in order to underwrite capacity in the AGP and NGP. Without PWC's GTAs, it might be said that the pipelines would not have been developed. Yet the Mereenie gas project would be able to use the Auction mechanism to secure capacity at no (or little) cost and at no risk; an outcome compounded by the fact that it would then be at a competitive advantage over PWC in relation to the acquisition and supply of gas. In addition, if the Mereenie Project were to win existing PWC customers based on this low cost advantage, it would create more available capacity for auction thus creating a downward spiral of reduced competitiveness. This would occur while the NT Government through PWC would continue to pay the full costs of the AGP Pipeline with no avenue for relief. Given such outcomes, shippers such as PWC, are likely to be hesitant about entering into GTAs to underwrite new long term investments, so that it is more difficult for pipeline operators to commit to and finance them. The chilling effect on investment could be profound.

PWC cannot see how such an outcome would be consistent with the COAG Energy Council's desire to achieve outcomes like those of a workably competitive market which promotes efficient investment in both new gas supply and transport.

A further side effect of the Auction mechanism would be to transfer wealth from NT taxpayers to the privately owned Mereenie gas project. That would arise because the NT Government, through PWC, would effectively subsidise the gas marketing initiatives of the Mereenie gas project.

For these reasons, PWC's preliminary view is that the Auction mechanism should not apply to pipelines in the NT. If, despite that, a decision is made to impose the Auction mechanism, then it should be introduced to a pipeline in the NT only if:

(i) there are multiple independent shippers/bidders (other than PWC), so that that there is an appropriate level of competitive tension in respect of, and competition for, capacity on the pipelines. Each of those shippers should hold a minimum level of firm capacity and be able to participate in the auction process; or

(ii) full and proper due diligence, acceptable to the NT Government, is completed and such due diligence demonstrates that PWC and the NT Government will not be financially disadvantaged.

PWC also considers that, for the Auction mechanism to apply to the NT in the near-term, the following conditions would need to apply until there are multiple participants in any Auction (on the basis outlined above):

(i) The minimum bid price should be greater than zero, with PWC's auditable, average cost of capacity being recommended. This is to recognise that an auction with only one participant will settle at the minimum price. This would enable the cost per GJ to reduce as pipeline capacity utilisation increases. In the worst case, the minimum transportation tariff set under the Auction mechanism should be equivalent to the reference tariff (for the relevant reference service) approved by the relevant regulator from time to time, adjusted in accordance with the relevant access arrangement (in practical terms, this would be the regulated tariff approved by the Australian Energy Regulator every 5 years).[2]

(ii) Proceeds from the auction process should accrue to PWC. This is because PWC has underwritten and is paying for all costs of the AGP, and the only bidder in an Auction would have little incentive to purchase capacity from PWC under the terms of a bilateral agreement.

4. CONTRACTED BUT UN-NOMINATED CAPACITY

PWC has noted that the AEMC suggested that gas pipelines that are not fully contracted should be exempt from the day-ahead capacity auction. This recommendation should not be dismissed.

In PWC's view, the NERA analyses - upon which GMRG relies to justify its recommendation that all gas pipelines should be subject to the Auction mechanism - should not be relied upon. Market fundamentals, such as the imperative that shippers have to contract for pipeline capacity to meet peak day requirements, have been ignored by NERA.

NERA has also ignored factors such as:

- the damaging consequences of skewing market competiveness by affording one party access to cheap capacity that is instead paid for by competitors; and
- the fact that it is preferable for party(s) to contract for available capacity, rather than to secure capacity through auction, so that the benefits of improved pipeline usage can be passed on to the entire gas market by way of reduced tariffs.

PWC considers that NERA's modelling conclusions are no more than a reflection of the behavioural assumptions upon which the model is based.

Ultimately, PWC considers that it would be inappropriate for the Auction mechanism to apply to gas pipelines that are not fully contracted.

---

2 If the pipeline in question is not a covered pipeline, or there is no approved access arrangement for the pipeline, then the minimum tariff should be set to be equal to the reference tariff that would be approved by the relevant regulator from time to time if the pipeline were covered and there was an approved access arrangement.

5. **RESERVE PRICE OF ZERO**

PWC understands that AEMO required that an Auction mechanism have a reserve price of zero. However, this seems inappropriate in the case of any gas pipeline for which there is only one party participating in the Auction.

In such a case, an Auction participant will not only be assured of securing capacity at zero cost, but will also have little (if any) incentive to purchase capacity under a bilateral agreement. The single Auction participant will in effect be afforded a discriminatory subsidy.

PWC submits that an outcome of this nature is not consistent with what would be expected in a workably competitive market. A party which values capacity the most should be prepared, and obliged, to pay for it.

6. **COMBINATORIAL AUCTION AND PROFIT MAXIMISATION**

While an Auction process that allows a single bid for capacity across multiple pipelines is a preferred outcome of the AEMC, PWC has concerns about the fairness of the GMRG's proposed approach to allocation between pipelines of proceeds from its revenue-maximisation approach.

One bidder may win capacity across multiple pipelines through having its entire bid allocated to one pipeline (thereby beating other bidders) but secure capacity for free in upstream or downstream pipelines for which it is the only bidder. PWC's preliminary view is that this seems inequitable.

A fairer allocation of (maximised) revenue is essential. Subject to the comments above, one option for consideration could be allocation of proceeds on a distance-weighted basis.

7. **PHASE-OUT OF AS-AVAILABLE RIGHTS**

PWC understands that the AEMC suggested that shippers' rights to as-available capacity be phased out.

PWC does not accept the reasoning behind this suggestion. Shippers that are underwriting pipeline costs through long-term contracts should be entitled to spare capacity in priority to access seekers who opportunistically acquire capacity through an Auction mechanism.

8. **RE-NOMINATIONS BY INCUMBENT SHIPPERS**

The AEMC has required that firm shippers' re-nomination requirements be accommodated. Given the daily swing in Territory Generation's nominations (as highlighted above), PWC strongly supports this requirement.

Market participants such as electricity generators are exposed to potentially rapid and extreme changes of demand, reflecting factors such as the nature and type of generation on a network including a significant quantity of renewables, temperature-sensitivities and system dynamics. This consideration is magnified in the NT due to its unique climate and the gas dependency of its generation system (both for normal generation requirements and ancillary services). PWC considers that these participants must be entitled to re-nominate as and when required in accordance with their contractual arrangements. In the NT context an inability to manage daily demand swings through intraday changes could put electricity supply to NT consumers at risk while also increasing costs to PWC and its customers in the generation sector.

9. BACKHAUL

Backhaul capacity is available for contract by any shippers who seek to use it. If backhaul capacity is used, then it should be paid for, and all shippers on the pipeline in question should benefit through a reduction in overall average tariffs.

PWC's preliminary view is that the inclusion of backhaul capacity in the Auction mechanism would lessen competition, effectively subsidising users of backhaul and compromising the competitiveness of users who have contracted and are paying for capacity (whether forward-haul or backhaul).

Accordingly, PWC does not support the GMRG's proposal that backhaul capacity be included in the Auction mechanism.

10. COMPENSATION FOR ACQUISITION OF PWC'S RIGHTS

As discussed above, PWC took significant risk by entering into long term GTAs for firm capacity, in order to underwrite capacity in the AGP and NGP. Without its GTAs, the pipelines may not have been developed.

The GTAs into which PWC entered were structured to provide PWC with the rights that it needs to effectively and efficiently manage its gas portfolio. It agreed to enter in them on the basis of a price, and package of rights and obligations, that reflects an appropriate risk and reward balance as between the pipeline operator and PWC. Importantly, that included rights in relation to MDQ, flexibility, nominations and renominations, and balancing.

PWC is seriously concerned about the potential loss of its rights under its GTAs and considers, as a matter of principle, that it is fair that it should be paid just compensation in the event that it loses the benefit of any rights.

In addition, PWC suggests that the imposition of statutory changes that override contractual benefits would have negative consequences for contracting and investment certainty in the energy industry, unless they are accompanied by just compensation.

For the reasons set out above, PWC believes that it would be imprudent to apply the proposed Auction mechanism to gas pipelines in the NT without carefully and closely considering how it might actually operate in the NT. Otherwise, there is a real risk that the Auction mechanism will lead to a range of adverse consequences.

PWC believes that it is necessary to defer the application of the Auction mechanism to pipelines in the NT until further due diligence is undertaken.

PWC is willing to participate in such a due diligence exercise, with immediate effect. That extends to making its people and advisers available to work with the GMRG (on both the Advisory Panel and Project Team).

If you would like to discuss any aspect of this submission, please contact Antoni Murphy, General Manager Gas Supply Unit on (08) 89857124 or by e-mail at antoni.murphy@powerwater.com.au

Yours sincerely

Michael Thomson

Chief Executive

6 November 2017