Submission

Operation and Administration of the Capacity Trading Platform(s) and Day-Ahead Auction

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Executive Summary

The reforms under consideration by the GMRG are expected to foster the development of a more liquid secondary capacity market.

A liquid secondary capacity market concentrated on an enhanced capacity trading platform offers benefit to all market participants, including pipeline operators. Pipeline operators see that a liquid secondary capacity market supports the primary market, enabling shippers to better manage their changing demand over time and manage the volume risk of long-term contracting.

In contrast, the day-ahead of auction for contracted but unnominated capacity can only be of benefit at the margin, if at all, to contracted shippers. Its original purpose was to incentivise greater volumes of capacity into the secondary market, not capture significant market liquidity itself. The GMRG should contemplate carefully the scope, design and implementation of an auction mechanism that likely presents benefit to only a small number of market participants – primarily those with limited contract positions and flexible supply options.

The implementation of the day-ahead capacity auction is a significant regulatory intervention. Mandating that this auction be conducted by a third party is a further, unnecessary intervention. To allow this third party to recover its costs from auction revenue, as opposed to an administrative fee charged to users, is even greater intervention. This level of intervention is contemplated in the consultation paper without any consideration if it is necessary to achieve the stated objectives.

APGA considers there are a number of critical detailed design matters to be resolved before a fully informed decision can be made on which party should run trading platforms and capacity auctions. Despite this, there are a number of factors that lead APGA to conclude that it is most appropriate that pipeline operators operate and administer day-ahead capacity auctions for contracted but unnominated capacity on their own assets.

The consultation paper states the objective of the capacity auction is to *"address contractual congestion and to undermine the market power held by pipeline operators in the market for day-ahead capacity".*

APGA's proposal for pipeline operators to operate and administer capacity auction delivers an auction that:

- addresses contractual congestion most effectively;
- supports a liquid secondary capacity market;
- balances the purpose of the auction reform with the need to maintain investment incentives;
- delivers auctioned capacity at the earliest possible time on a gas day; and
- does so at least cost with the least regulatory intervention.

APGA believes the proposal best meets the NGO and the Council's Vision for the Australian Gas Market, both of which place significant importance on investment.

Introduction

The Australian Pipelines and Gas Association (APGA) is the peak body for Australia's gas transmission sector. Our membership includes the owners, operators, designers, builders and service providers of high-pressure gas pipelines.

APGA has been an active participant in the processes that have led to the current consultation and welcomes the opportunity to comment on the Gas Market Reform Group's (GMRG) Consultation Paper on the Operation and Administration Capacity Trading Platform(s) and Day-Ahead Auction.

APGA appreciates that this consultation is being conducted through public written contributions to the GMRG's consultation and believes there may be value in the GMRG seeking further opportunity to engage with stakeholders in this way.

Timing of the recommendation on the organisation(s) to operate and administer capacity trading platform(s) and the day-ahead auction

The Consultation Paper sets out on page 4 that the GMRG has examined opportunities to accelerate the development work of these reforms and expects to make recommendations on:

- the organisation(s) designated to operate and administer the capacity trading platform(s) and the day-ahead auction by mid-2017;
- the form that the standardised capacity trading contracts and the capacity trading platform should take by September 2017; and
- the design of the day-ahead auction and the reporting framework for secondary capacity trades by December 2017.

APGA does not consider that a fully informed recommendation on the appropriate organisation(s) to operate and administer the trading platform and the day-ahead auction can be made in advance of finalising their design. This is particularly relevant for the day-ahead auction. Design considerations that are directly relevant to deciding which organisation(s) are best placed to deliver the day-ahead auction include:

- determining which pipelines the auction will apply to;
- the service to be auctioned, including characteristics such as its place in the curtailment order and the specificity of its delivery and receipt points; and
- determining the amount of capacity to be released through auction.

These matters are under active consideration by the GMRG and the day-ahead auction project team.

As it stands, stakeholders are being asked to provide feedback to the GMRG on proposals that have been made by the Australian Energy Market Operator (AEMO) and APGA. AEMO's proposal to run capacity auctions is specific to a highly simplified auction that:

- is not concerned with specific receipt and delivery points for each bid, thereby simplifying the auction in a way that may impact deliverability of auctioned capacity;

- assumes auctions will be conducted on all pipelines and that contingent bidding across pipelines will be required, thereby potentially over-emphasising the potential benefit of a centralised auction; and
- minimises data inputs for and algorithmic complexity of the auction, lowering the implementation cost.

Each of these issues is under active debate.

Making such assumptions has enabled AEMO to present a cheap and easy auction proposal that leverages an existing auction engine. If any changes are made during detailed design, it is highly unlikely AEMO will be able to meet its low-cost estimate.

The proposal that APGA has presented suits itself to the more complex auctions that may be required by participants. For example, if bids are matched to specific receipt and delivery points, more capacity may be available to be released through auction. This will be especially beneficial in times of peak demand and will do more to address contractual congestion at these times.

APGA and its members have found it very difficult to develop credible proposals for the operation and administration of the capacity trading platform(s) and day-ahead auction in the absence of a detailed design for either. In the current environment, it does not seem appropriate for APGA and pipeline operators to be making the assumptions on design characteristics that are necessary to properly construct and cost a proposal.

APGA encourages the GMRG to contemplate delaying the decision on the operation and administration of these reforms until after key design features have been finalised. At such a time, APGA would be happy to co-ordinate a comprehensive revised proposal from the pipeline industry that meets set specifications.

The package of reforms

As the consultation paper makes clear, there are a range of reforms set out in the CoAG Energy Council's Gas Market Reform Package.

The interaction of the reforms detailed in the consultation paper and other reforms in the Gas Market Reform Package, such as the information disclosure and arbitration framework, need to be assessed and considered throughout the development of and consultation on the detail of each reform.

Constraining Market Power

One issue where the role of each reform needs to be clearly understood is that of market power. The consultation paper states that the objectives of the day-ahead auction for contracted but unnominated capacity is to *address contractual congestion and undermine the market power held by pipeline operators in the market for day-ahead capacity*.

APGA notes that the ACCC found, in its East Coast Gas Inquiry, that the pricing of 'as available' services on all but three pipelines was:

The as available and interruptible charges levied by most pipelines are lower than would be implied by multiplying the pipeline's average load factor by the firm transportation charge.[1]

Subsequent to the AEMC's recommendation on auctions, the Examination of the Coverage Test for Gas Pipeline has recommended that pipeline market power be addressed through the implementation of an information disclosure and arbitration framework applying to all non-scheme pipelines. This framework will serve to address perceived issues of pipeline market power on all services. Where the issues may pertain to a scheme pipelines we also note that the AEMC has commenced a review of Parts 8-12 of the NGR and will review what services are considered to be reference services to further address any residual market power that may exist.

As such, this should no longer be considered a primary objective of the capacity auction. This leaves the main objective of the capacity auction to be addressing contractual congestion. This is achieved by:

- Incentivising shippers to make capacity available for trade in the secondary market; and
- Releasing that contracted but unnominated capacity to the market on a day-ahead basis.

Contractual congestion only exists on pipelines that are fully contracted.

Where should liquidity be concentrated?

The outcome being sought from the collective reforms being progressed by the GMRG is to *foster the development of a more liquid secondary capacity market*.

In developing the detail of the reforms, it is necessary to acknowledge the AEMC's intent in recommending the reforms was to develop liquidity in the secondary capacity market, the market in which existing shippers trade their unused capacity with other shippers and users, and the role each reform should play in achieving this.

The day ahead auction for contracted but unnominated capacity is effectively part of the primary market, as the pipeline operator is the only party that can sell such short-term capacity.

Further, the day-ahead of auction for contracted but unnominated capacity can only be of limited, if any, utility to contracted shippers. A service that is not useful to all participants cannot be a primary driver of liquidity in capacity or gas markets. The GMRG must contemplate carefully the scope, design and implementation of an auction mechanism that likely presents benefit to only a small number of market participants.

[1] P110, ACCC East Coast Gas Inquiry

In contrast, a liquid secondary capacity market concentrated on an enhanced capacity trading platform offers benefit to all market participants, including pipeline operators. Pipeline operators see that a liquid secondary capacity market supports the primary market, enabling shippers to better manage their changing demand over time and manage the volume risk of long-term contracting.

The focus should be on establishing the most useful capacity trading platform and determining the most effective means of incentivising sellers and buyers of capacity to concentrate their activity there.

APGA is concerned that there is some focus on designing the most sophisticated auction, particularly one that benefits new entrants with flexible supply capability, with the broadest possible application as opposed to an auction that complements primary and secondary markets and provides the best possible incentives to drive liquidity in the secondary capacity market.

Delivery of an auction with service that has high value to a small number of market participants may well deliver new entrants some short-term benefits (it is not likely benefits would extend much beyond new entrants). However, it would place existing shippers, that have supported pipeline investment, at a disadvantage and reduce their incentives to support future pipeline investment or maintain current contracting levels. An auction for contracted but unnominated capacity can only work as long as shippers continue to contract. Where a pipeline has spare capacity, there is no contractual congestion to address.

The GMRG must clearly establish and articulate what the desired outcome of the auction process is and how it interacts with other reforms. This should help to better guide detailed design discussions but will also help inform the decision of which party is best placed to operate and administer auctions.

Incentives for buyers to participate in the secondary capacity market

The consultation paper notes that one of the means by which the AEMC sought to support development of a liquid wholesale market is by *improving the incentive shippers have to trade capacity.*

The AEMC recommended the day-ahead capacity auction with this incentive in mind. The day ahead auction was presented as, essentially, a low intervention, short-term 'use it or lose it' mechanism. Shippers that do not trade the capacity they are not using in advance will have it made available to the market on a day ahead basis through auction.

The incentive for shippers is clear – make unused capacity available at reasonable rates or have it released to the market through auction. The benefits are also clear, shippers have ample opportunity to make this capacity available to the market in the months, week and days leading up to a particular gas day and reduce sunk costs through trade revenue.

Once shippers start realising additional revenue through trade on pipelines that are required to conduct the auction, it is reasonable to expect they will leverage the trading platform and internal processes in place to expand the revenue potential by making capacity available for trade on as many pipelines as possible.

To develop a liquid secondary capacity market, it is necessary that buyers of secondary capacity also have incentive to buy the capacity made available for trade.

Picking up APGA's observation above, if the day-ahead auction is developed in such a way that it is the primary driver of liquidity and a major new option to acquire capacity, it is very possible that buyers will see little value in acquiring capacity through the enhanced trading platform(s). The incentives for buyers to use the enhanced trading platform are diminished if:

- The capacity available through auction has equivalent service levels to the firm capacity available through primary and secondary markets. If auction capacity is firm, pipeline operators will have to provide the highest service level at a very low price.
- The auction is applied to all pipelines regardless of contracting levels. As noted above, APGA anticipates shippers will make capacity available for trade on all pipelines once they have established the systems to do so on pipelines subject to auction (and are benefiting from it).
- In combination with a broad application of the auction, the ability to make contingent bids across all pipelines is made available. Currently transport across multiple pipelines can only be achieved through negotiation with each pipeline operator. The enhanced capacity trading platform(s) will offer a new way to do this. If this can also be achieved through auction, the value of conducting this activity through the trading platform(s) is diminished.
- The capacity made available through auction is extended beyond 'contracted but unnominated' either through off-set of counter flow and/or backhaul. As the amount of capacity available through auction increases, its scarcity (and thus cost) diminishes.
- There few risks in buying capacity through auction. If the service offered through auction is firm, pipeline operators have to take on the highest level of liability for delivery of a service they are unlikely to realise any revenue from. If firm services are of value to shippers, they are available through the primary market and secondary market. Further, those shippers that do make their capacity available for trade through the enhanced trading platform(s) will also be providing clear signals to the market of their capacity utilisation, enabling buyers to assess their exposure to interruption through auctioned capacity.

APGA appreciates that these issues are not the subject of this consultation paper. Each of these issues must be investigated thoroughly, there are additional aspects to each issue other than their impact on buyers' incentives to trade that must be considered. For example, an auction implemented with all the above characteristics would also have major implications for investment incentives.

As covered below, some of these are design issues that do have some relevance to which party is best placed to operate and administer the trading platform(s) and auction.

APGA does consider that, in addition of undermining the incentives for buyers to participate in the enhanced capacity trading platform(s), none of the characteristics above materially improve the ability of the auction to address contractual congestion on pipeline.

How much intervention is appropriate/necessary?

An issue not contemplated by the consultation paper is the level of regulatory intervention embodied in each proposal.

Regulatory intervention is inherent in the reform package. The CoAG Energy Council has decided, based on the AEMC recommendation, that a day-ahead auction for contracted but unnominated capacity will occur on pipelines. It is APGA's observation that many participants in the consultation appear to have little appreciation for how big, and uncommon, an intervention this is.

In addition to pipelines being mandated to sell a service in a particular way, this consultation paper is contemplating further intervention through:

- Mandating the sale process be controlled by third party.
- Allowing the third party to recover its costs from the revenue derived from the service. There is currently no contemplation of any controls over these costs.

Allowing AEMO to recover costs through auction revenue raises a further issue of equity. If the majority of auction activity is taking place on a small number of pipelines, it is the owners of these pipelines that will be effectively funding the auction for the small number of market participants who stand to gain most of the benefit from it

An additional relevant matter not under consideration at this time is whether pipeline operators will be able to continue offering 'as available' services directly to shippers at all.

Best practice policy making seeks the option that will deliver the required outcome at the lowest cost and with the least intervention.

This aspect of the auction reform stands in contrast to the establishment of a capacity trading platform, which will be a voluntary marketplace.

Assessment Framework

The assessment framework presented in the consultation paper is a reasonable starting point for making a preliminary assessment of the options available for parties to operate and administer the trading platform(s) and capacity auction. Two important issues that should be included in the framework are:

- The level of regulatory intervention embodied in each option.
- The likely effect on liquidity in the secondary capacity market of each option.

In any event, in the absence of detailed design it is not possible to perform a thorough assessment.

AGPA also considers it appropriate that the assessment framework for each service provide a clear statement on the purpose and intent of each reform. In the case of the capacity auction, APGA has set out above that there is a difference between the implementation of an auction that incentivises participants to trade on in the secondary capacity market and the implementation of the best possible auction for new entrants. Which one is being assessed in the framework?

The consultation paper's introduction to Chapter 4, covering auctions, states the AEMC's objectives in recommending the auction were to address contractual congestion and market power. Neither of these objectives are mentioned in the assessment framework and aspects of each proposal are assessed without reference to them. For example, the AEMO proposal for auctions receives a tick on the co-ordination criterion because it enables contingent bidding across pipelines, but questions not asked include:

- Is contingent bidding necessary to address contractual congestion or market power?
- Does contingent bidding in the auction reduce incentives for buyers to participate in the secondary capacity market?

As many of APGA's comments on the application of the assessment framework to the proposals are relevant to both the trading platform(s) and the auction, APGA will cover both in the following commentary.

Operated by an independent and experienced operator

The consultation papers gives AEMO a tick and pipeline operators a cross for both the capacity trading platform and the day-ahead auction.

This position fails to provide any recognition to the role pipeline operators currently play in the market.

Pipeline operators run sophisticated nomination and scheduling systems that ensure all gas used in Australia is delivered each and every day.

Pipeline operators have put in place capacity listing services and developed the operational capacity transfer service that will underpin the trading of capacity through the capacity trading platform.

Pipeline operators manage the MOS stack that underpins the STTM – effectively overseeing the allocation of balancing gas based on a bid stack. This is a very similar process to running an auction for capacity allocation.

Pipeline operators have a track record of delivering low-cost innovative service to the gas market. These services include an appropriate allocation for risks and are paid for by shippers that use the service. Where new services are not taken up by shippers, pipeline operators bear the costs as they are not recovered through tariffs.

In contrast, AEMO has a track record of delivering relatively costly services that tend to smear costs across all market participants and push many risks back onto market participants.

Concerns about the independence of pipeline operators seem to be concentrated on two matters:

1. In the case of the trading platform, some market participants appear to be concerned that pipeline operators having full insight into bidding activity will provide them an opportunity to undercut the prices being offered on the trading platform.
2. In the case of the auction, some market participants appear to be concerned pipeline operators will withhold capacity from the auction to drive prices higher.

In both cases, the concerns apply regardless of which party operates and administers the service and they are easily mitigated through transparency and effective oversight.

1. Bids and offers will be visible to pipeline operators on the capacity trading platform regardless of who operates it and pipeline operators will see the market value of secondary capacity. It should be expected that this influences primary capacity pricing and, indeed, this would appear to be a beneficial outcome for all market participants. If the behaviour is undesirable, the new transparency measures being implemented as a result of the AEMC review and contemplated by the GMRG should make it observable to all market participants.
2. Pipeline operators will determine how much capacity is available for auction regardless of who operates it. Transparency and regulatory monitoring is appropriate to assure the market the correct amount is being released.

Operated in a reliable and predictable manner

The consultation paper assumes both AEMO and pipeline operators are capable of operating the services in a reliable and predictable manner.

Operation underpinned by a robust governance framework

The consultation papers gives AEMO a tick and pipeline operators a cross for both the capacity trading platform and the day-ahead auction.

This is unreasonable. The governance framework accredited to AEMO is effectively the NGR. Changes to the NGR will be required to give effect to the auction regardless of who runs them.

These changes can mandate obligations for AEMO or pipeline operators.

Pipeline operators work with their customers constantly and have demonstrated their ability to deliver systems that meet their needs.

Transparency in costs and operation

Transparency in operation will be mandated for the operator of the trading platform and the day-ahead auction.

On the issue of costs, pipeline operators have proposed to absorb the costs of developing their proposal, however the AEMO proposal offers no details on how the costs will be controlled or minimised – only that the proceeds of the auction will be paid to pipeline operators only once AEMO has recovered their costs for running the auction. Whilst this may seem irrelevant to trading participants it sets a dangerous precedent for Industry and should be a key consideration for policy makers looking to preserve investment incentives.

Low transaction costs and quick and effective execution of transactions

The execution of capacity trades and auctions requires communication with pipeline operators' systems. This means pipeline operators have the ability to deliver these services at lower cost and more rapidly.

This is particularly relevant for the capacity auction, which is time sensitive and delivers greater benefit to the market the earlier it is completed.

The APGA proposal for capacity auction does require bidders to submit bids to each pipeline operator rather than a centralised operator. However under both models, shippers still need to return to the individual pipeline operator systems to submit nominations so it is unlikely that this is a real driver of cost or complexity.

Integrated with pipeline operator nomination and scheduling processes

Shippers make nominations on a daily basis, regardless of how capacity is acquired. This will not change as a result of introducing these reforms.

The consultation paper assesses this criterion equally for both AEMO and pipeline operators' services. This is not correct. Processes run by pipeline operators will have greater integration with pipeline operator nomination and scheduling processes and systems. It should be expected that the greater level of integration with pipeline operator nomination and scheduling processes and systems provides greater optionality for the development of more sophisticated services over time.

For example, APGA understands that the fully anonymous trading option requires a high level of integration with pipeline systems. The costs of this has not been included in AEMO's proposal

Shippers can co-ordinate trades across pipelines

The consultation paper assesses centralised option favourably for both the trading platform and the capacity auction. In the case of the capacity platform, APGA agrees with the assessment that a centralised platform will enhance the co-ordination of trades across pipelines. This will serve to enhance liquidity in the secondary capacity market.

In the case of the capacity auction, coordinating trades across pipelines suggests a broad application of the auction and a utility to all market participants. As noted above, the scope of the auction has not been determined, and there are clear policy reasons why the auction should not be applied broadly.

APGA considers that with regard to the auction, all including the capacity available, will be published in a centralised location under both proposals. This centralisation of information facilitates a sufficient level of co-ordination.

The consultation paper has a favourable view that the AEMO auction proposal can deliver contingent bidding across pipelines. APGA understands why contingent bidding is favourable to a number of market participants. Being favourable to a number of market participants does not mean it delivers the best result for the secondary capacity market. It is not clear to APGA that contingent bidding is needed to address contractual congestion or market power of pipelines or that it will increase liquidity in the market for secondary capacity.

Shippers can co-ordinate trades between the capacity trading platform and the auction +

Shippers can co-ordinate trades with other services on the Gas Supply Hub

For these two criteria, the consultation paper appears to do little more than assess the AEMO option as superior because it proposed to house the trading platform and the auction in the same web portal. This does not seem to be particularly relevant. They will not be delivered as an integrated service. They will be two separate services on the same website. An active trader of capacity will still need to have multiple tabs open to manage activity.

More relevant to the co-ordination of trade is the timing of the auction, particularly the time at which bidders are informed of the auction results. This is unquestionably earlier if pipeline operators run auctions. The earlier delivery of auctions is arguably far more important to the co-ordination of trades across platforms and hubs yet has been given no value in the assessment framework.

Capable of capturing scale and scope benefits +

Future proof, scalable and adaptable

The opportunity for greater integration into pipeline systems and processes has been undervalued in the consultation paper's assessment of these criteria. Pipeline operators have to be involved in the allocation, nomination and scheduling of capacity acquired through trade and auction. Having pipeline operators operate and administer the platforms delivering these services provides ample opportunity for growth, innovation and improvement over time.

Capacity Trading Platform(s)

Single Platform

At this time, APGA supports the development of a single, centralised capacity trading platform.

This is most likely to facilitate increased liquidity in the secondary capacity market and will enhance the ability of shippers and buyers to trade transportation services across multiple pipelines

Operator of the platform

As noted above, APGA does not support the GMRG making a recommendation on the operator and administrator of the capacity trading platforms until the detailed design is resolved. This will enable a fully informed, and costed, decision to be made.

Given that AEMO is currently an active participant and providing detailed design options to the Capacity Trading Project Team, it appears this decision has already been made.

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Day Ahead Auction

Pipeline operator should operate and administer auctions

APGA's proposal for auctions run by pipeline operators delivers a service that achieves the objectives of the reforms at the lowest cost. Importantly, APGA's proposal:

- Provides auctioned capacity to market participants at the earliest possible time, providing it greater potential to be co-ordinated with market activity.
- Anticipates maximising available capacity at every receipt and delivery point, providing the greatest capability to address contractual congestion in times of peak demand.

APGA's proposal also recognises that an auction for contracted but unnominated capacity does not benefit all market participants and should not deliver a product that is equal to contracted capacity in terms of service levels or potentially even superior, in the case of contingent bidding across pipelines. If the auctioned product does have equal or superior qualities to contracted capacity, there will be less incentive for shippers to enter into firm contracts or trade on the platform. The risks associated with contracting (where a competitor can gain access to a pipeline through the auction without contributing to costs) will in turn disincentivise shippers from underpinning new capacity.

APGA's proposal delivers an auction that:

- addresses contractual congestion most effectively;
- balances the purpose of the auction reform with the need to maintain investment incentives;
- delivers auctioned capacity at the earliest possible time;
- incentives shippers and buyers to participate in the secondary capacity market; and
- does so at least cost with the least regulatory intervention.

APGA believes the proposal best meets the NGO and the Council's Vision for the Australian Gas Market, both of which place significant importance on investment.