12 February 2015

Tom Walker
Project Leader
Australian Energy Market Commission
Submitted via website
AEMC reference - GPR0003

Dear Tom,

RE: Stage 2 Draft Report

Thank you for the opportunity to provide comment on the Australian Energy Market Commission's (AEMC's) Stage 2 Draft Report (draft report).

Stanwell's interest in the gas market is as a trader of gas and industrial buyer for the gas-fired Swanbank E and Mica Creek power stations. Swanbank E power station has a capacity of 385MW and is located 10km from Ipswich, QLD. Mica Creek power station is 218MW and is located near Mount Isa, QLD. Stanwell is an active participant in the Brisbane Short Term Trading Market (STTM) and the Wallumbilla hub.

Auction for contracted but un-nominated capacity

Stanwell is concerned about the proposal for a firm day-ahead auction for contracted but un-nominated firm capacity. Stanwell has renomination rights which enable us to renominate up to 2 hours before the end of the gas day. Although acceptance of the renominations are at the pipeline's discretion, we rely on these renomination rights of firm capacity to ensure that we can profitably and flexibly operate Swanbank E in the electricity market. The auction proposal will result in an implicit reduction in the firmness of our renomination rights.

Stanwell also understands that the standard gas transportation agreement (GTA) includes re-nomination rights for all services[1]. Once accepted by the pipeline, these renominations are scheduled with equivalent curtailment priority as to day ahead nominations for the same service.

If there is a curtailment event, that is the capacity of the pipe is insufficient to receive, transport or deliver all the quantities of the gas scheduled to all users, then users are curtailed in a defined order whereby firm users are curtailed last.

If the auction allocates day-ahead capacity on a "firm" basis (equivalent to that offered under Firm Transportation Agreements), then all users with agreements other than the "firm" agreement are incentivised to purchase firm capacity through the auction rather than nominate under their own agreements. This will enable them to purchase more certain capacity (in a curtailment event) at a cheaper price. As a result, users with Firm Transportation Agreements are more likely to be curtailed if the scheduled gas exceeds the capacity of the pipe than would currently be the case. This is an unacceptable result which devalues existing firm transportation agreements and reduces the incentive to enter into firm GTAs. Lower order GTAs (as available, interruptible etc) would also be impacted as they would experience a higher incidence of curtailment for minor to moderate events.

[1] Firm, As Available, Authorised Overrun, Interruptible, Backhaul, Redirection, In-pipe trade

If the auction proposal were to go ahead, the capacity allocated through the auction must not be ranked "firm". Otherwise the auction has the potential to devalue existing contracts and change the incentive for entering into longer term agreements.

Under the standard GTA, the pipeline also has the right to reject a renomination "at its discretion and without liability to the shipper". In practice, it is Stanwell's understanding that pipelines accept the vast majority of renominations under system normal conditions. If firm capacity is sold through the auction, then it may be more likely that the pipeline will reject a renomination. However, evidence of such an impact may be difficult to determine due to the opaque nature of the pipeline's decision making process.

Stanwell is also unsure as to how the day-ahead auction will provide any additional incentive to trade capacity ahead of the auction. Firm shippers currently receive nothing if they don't sell the capacity that they don't plan to nominate, and this is not proposed to change. Conversely the incentive on buyers has changed dramatically. Buyers who were previously incentivised to purchase secondary capacity or enter into primary GTAs will have this incentive diluted by the opportunity to purchase capacity through the auction at a very low[2] reserve price. In either case, the firm shipper continues to pay for all of its capacity (whether nominated or not).

Stanwell also questions the usefulness of the day-ahead auctions. These auctions are unlikely to be relied upon by participants unless they have an existing transport agreement in place (potentially of a lower scheduling order). For example, if a participant purchases day-ahead gas at Wallumbilla, and subsequently is unable to obtain capacity through the auction, then it is likely to be too late for the participant to make other arrangements.

The auction design and implementation process will be complex. There will be different transportation routes, receipt points as well as contingent bids etc. If capacity trading is already occurring as a result of the AEMC's other recommendations, then the costs incurred to design the auction and set a reserve price will be inefficient.

Stanwell is also concerned about the information that may be gleaned from the capacity available (or traded) at the auction relating to the operation of gas fired power stations. The revelation of this information would put gas fired power stations at a disadvantage in the electricity market. Because of this, the publication of traded day ahead capacity volumes should be delayed until after the conclusion of the electricity day.

Secondary trading platform with information reporting requirements and standardised capacity products

Secondary capacity trading platform

The AEMC has recommended that pipeline owners be required to operate an internet based capacity trading platform where shippers can anonymously post bids or offers for capacity. This proposal relies on the ability to create fungible, standardised portions of capacity from existing and new GTAs. Stanwell assumes that once matched, the names of the shippers are revealed to each other. The capacity trading platform need not be complex for example it may be unnecessary for the trading platform to facilitate payments between shippers. The

[2] "an appropriate reserve price might theoretically be the short run marginal cost of capacity - operational costs required to provide an additional unit of capacity", Page 60

AEMC should also consider the costs and benefits of the pipelines running the platform versus an independent party such as AEMO operating the platform.

Trade reporting

The AEMC has recommended that all capacity trades, including those operating outside of the capacity trading platform, be required to be published. This includes information on

- Size and duration
- Price, and price for related services such as renomination
- Details on any other terms and conditions

Stanwell supports this initiative for standardised, fungible portions of capacity where they do not reveal a gas fired power station's future operating intent. Where they do reveal a gas fired power station's future intent, we support publishing this information after the transport agreement has concluded. We do not support this initiative for bespoke negotiated agreements.

Gas fired power stations operate in the highly competitive wholesale electricity market. Any revelation of capacity trades relating to gas fired power stations would put gas generators at a commercial disadvantage. If sensitive capacity trade information is required to be reported, this may reduce the incentive for capacity trading by gas fired generators. For example, if a gas fired power station has a 1 month scheduled outage in 6 months time it may choose not to sell its 1 month of capacity if reporting of the sale revealed to other generators that the power station would be offline for this period.

We also do not support the publication of bespoke contracts. The terms of bespoke contracts could be complex and the price may not provide accurate guidance as to the price available for a different (or standard) contract. It is also likely to be burdensome to report details of privately negotiated bespoke contracts. There are likely to be terms or prices which may not be easily explained through a standardised reporting platform. In addition, there are confidentiality concerns. Some of the terms negotiated may reveal the forecast operation of a facility such as a change to its operating mode. The revelation of this information could impact on the facility's competitiveness in other related markets (such as electricity, LNG, retail gas).

In the electricity market, standardised products have developed which are both exchange traded as well as traded over the counter. These products are widely traded and understood, simple to transact and have a clear price reference. However these products do not meet all the hedging requirements of generators and retailers. Generators and retailers must also enter into bespoke agreements over the counter including day-ahead hedges, hedges for only certain hours of the day, structures where the volume hedged is not known in advance, caps with non-standard strike prices etc. Retailers have also frequently sought to "self hedge" through acquiring or building generation assets.

In the electricity market every trade which occurs on the exchange is reported anonymously. In addition, standardised over the counter trades which occur through brokers are usually reported by brokers and incorporated into their daily trade summaries. Bespoke hedges are predominately traded directly between participants. The terms are sometimes complex and require significant time and legal investment to finalise. The price is also negotiated between counterparties based on numerous factors including the price of the closest standard product, the credit rating of the counterparty, the settlement terms, the options implicit in the product etc. Bespoke, negotiated electricity hedges are not reported.

Stanwell envisions the gas capacity market working in a similar way in the future. By reporting standard capacity trades, search and transaction costs would be reduced and liquidity would be increased in standard products. The negotiation of bespoke contracts would also benefit as the price of standard contracts would be useful in determining a price for bespoke contracts. This market can function, as the electricity market functions, through the reporting of standard contracts but not the reporting of bespoke agreements.

The AEMC has also suggested that "shippers would not be allowed to transport gas on behalf of a third party (a practice known as 'bare transfers') circumnavigating reporting requirements"[3]. Stanwell understands the AEMC's intention in making this statement is to improve the transparency of capacity trades however a prohibition on bare transfers is likely to restrict capacity trading. Many capacity trades are conducted through bare transfers for reasons including bespoke terms, contractual ease, lack of operational staff to make nominations, privacy concerns etc. Stanwell's experience is that bare transfers are the most common form of secondary trade. Rather than disallow bare transfers, Stanwell recommends that where a bare transfer has occurred in the form of a standardised capacity trade, that this be reported.

Standardised primary capacity products

The AEMC recommends that "standardised capacity products be required to be developed by industry, with regulatory oversight, with the intention of precipitating the standardisation of secondary capacity that is traded"[4].

Stanwell supports the intent of this recommendation in that standardisation is more likely to result in a fungible traded product. However, a standardised primary capacity contract could never be compulsory as shippers require different terms, or value some terms higher than others, depending on their operations. In addition, it is likely to be time consuming and difficult for existing GTAs to be fully converted to standardised GTAs.

Stanwell suggests a standardised secondary capacity product should be developed first. The product could then be used by existing holders of GTAs to perform bare transfers and as a reference for new primary GTAs. The standardised secondary product could also be the product listed on the capacity trading platform.

Information regarding primary capacity trades made transparent

The AEMC recommends that "the actual (not advertised) price of all primary capacity sales, and terms and conditions of those sales which might impact the price, be published"[5]. Stanwell does not support this recommendation. It is enough that the price of standardised secondary products be published. Primary capacity trades usually contain differing negotiated terms which would be hard to publish in a useful manner. For example, the standard GTA is 91 pages long but the final negotiated GTA may be longer with terms and conditions unique to each participant.

Stanwell is also concerned that the publication of primary capacity sales may reveal commercially sensitive information relevant to a participant. Even if the information was

[3] Page 63
[4] Page 63
[5] Page 73

published without names, it is likely that the names of the parties involved would be easy to deduce from the other terms in the contract.

Wholesale gas markets

Stanwell supports the AEMC's decision to retain the Wallumbilla Hub as a physical hub. Stanwell notes that AEMO is currently working on implementing the Optional Hub Services model at Wallumbilla to consolidate the three existing trading points into a single trading location. Stanwell's understanding is that the default location for the single trading location has not been confirmed and that participants will work with AEMO in the near future to define this location.

The AEMC states that over time the market may need to transition from a physical hub to a virtual hub because the Wallumbilla hub has a "lack of delivery certainty after trades have been matched on the exchange"[6]. Stanwell considers this concern to be unfounded and is not aware of any trade that has not been fulfilled at Wallumbilla. The participants at Wallumbilla are large, sophisticated participants who are unlikely to risk the reputational and financial penalties of non conformance with their contractual obligations. In addition, the risk of non delivery at Wallumbilla is not materially worse than what users currently receive under their bi-laterally negotiated Gas Supply Agreements.

With this in mind, Stanwell recommends the immediate scaling back of the STTMs (or at least the Brisbane STTM) to a balancing market. This will have the benefit of reduced costs for participants as the STTMs are expensive and continue to get more costly, as discussed in Stanwell's earlier submissions. In addition, liquidity is more likely to be enhanced at Wallumbilla if the Brisbane STTM is scaled back. It is unreasonable for the AEMC to recommend a transition to a virtual hub at Wallumbilla if liquidity does not develop if Wallumbilla has not had the chance to operate with balancing-only STTMs. An additional benefit of this proposal is that as the scaled back STTM retains the balancing component, the impact of any non-delivery at Wallumbilla is reduced.

Reviewing gas market liquidity

The AEMC says "should the recommended auction for contracted but un-nominated capacity, combined with improvements to facilitate secondary capacity trading result in insufficient levels of trade, then the Commission recommends that the introduction of a long term Use It Of Lose It (UIOLI) mechanism be reconsidered"[7]. The AEMC also says "over the long term, the Commission's view is that the [Wallumbilla] market may need to transition from a physical hub to a virtual hub"[8]

The AEMC should be aware that the threat of significant regulatory change, such as that envisaged in the statements above, can be extremely detrimental to market liquidity. Many participants will hold off entering the market, or will not enter into long term agreements, if they understand a major change to be threatened. Stanwell has experienced the negative effects of this in the electricity market when forward contract liquidity dried up due to the uncertainty regarding the introduction and removal of the carbon tax. This was a serious

[6] Page 83
[7] Page 70
[8] Page 83

problem, which lasted on and off for years and which greatly increased the risk profile of all participants.

The AEMC has published some measures through which to assess the evolution of liquidity. These are listed below.

Measure	Description	Liquidity requirement
Ratio of market participants actively trading at the hubs to physical players on the east coast	Measures level of participation at the exchanges relative to physical participants in the gas market	≥100%
Price relevance threshold	Number of trades required per product/hub/pipeline/trading-day so that the price signal can be considered trustworthy	≥15 trades
Liquidity threshold	Amount of gas simultaneously offered/requested (ask/bid) for a product on a hub so that the product is considered "liquid"	≥10,000 GJ
Liquidity trading horizon	Time horizon within which trading in gas products should be possible with the market being in a liquid state	≥12 months

Stanwell is concerned that these measures appear to be overly ambitious. The forward electricity market would not meet some of these criteria and yet there is no threat of regulatory intervention. Forward hedging is possible and the market is generally considered to be liquid (but not highly so). There are also numerous banks and hedge funds trading in this market along with the involvement of the ASX.

Even if set at a more realistic level, the liquidity measures should not be used as a mechanistic trigger to pre-determined further reform. The measures could be one of several inputs regulators consider when deciding whether further review is necessary. The solution developed as part of any future review would then be appropriate to the problem identified at that time.

Thank you for your consideration of Stanwell's response to the draft report. If you would like to discuss any aspect of this submission, please contact Jennifer Tarr on 07 3228 4546.

Regards

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