



Report to Minister of Energy

Wholesale Market Work Stream

20 December 2006

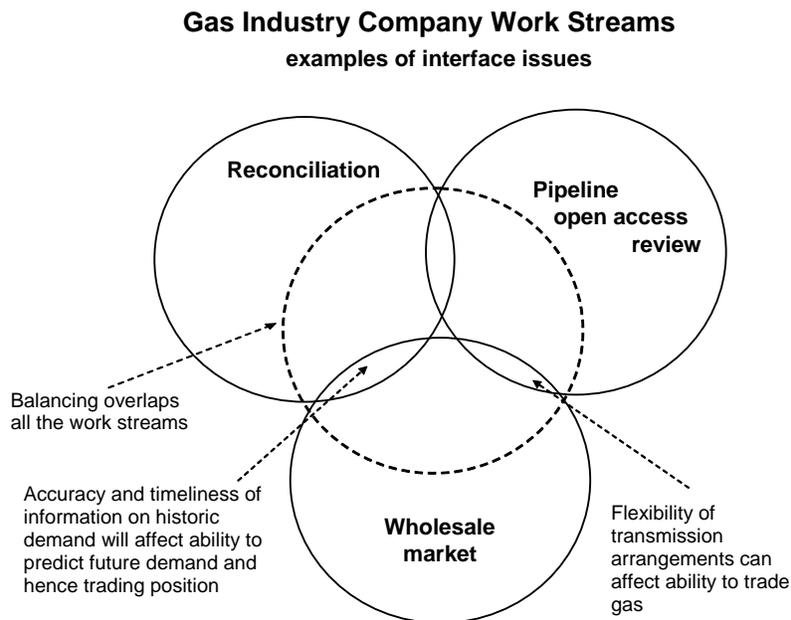
1 Introduction

Purpose

- 1.1 This report provides an update on work being carried out by Gas Industry Co on core wholesale market arrangements. It forms part of the ongoing reporting between Gas Industry Co and the Government.

Gas Industry Co approach

- 1.2 Gas Industry Co's general approach is to identify reasonably practicable options to achieve the GPS objectives, to analyse their relative merits and to select a preferred option for consultation.
- 1.3 This approach is being applied in the wholesale market work stream, starting with conceptual level issues, and working progressively through to detailed design.
- 1.4 Whilst the focus of this update is on the core wholesale market work stream, Gas Industry Co is also undertaking a development programme across a number of other work streams that have implications for the wholesale gas market (as illustrated below).
- 1.5 During 2006, Gas Industry Co has released papers on wholesale market design issues, pipeline access, reconciliation issues, and gas contingency planning.



- 1.6 This paper reports on progress in relation to the core wholesale market work stream, and the expected next steps.

2 Overview of Process

Conceptual Design Discussion Paper – March 2006

- 2.1 In March 2006 Gas Industry Co released a paper titled *Concept Design for Wholesale Gas Market* for stakeholder comment. That document outlined five broad options for development of the wholesale gas market. The paper assessed the options against a set of qualitative criteria, and concluded that the electronic trading of a bilateral contract on a voluntary basis should be pursued as the preferred option.
- 2.2 Stakeholder feedback was sought on the paper. Eight organisations responded representing gas suppliers, transporters and traders. The weight of submitters' views indicated:
- qualified support existed among stakeholders for taking the preferred option forward to the next stage;
 - a staged approach would be favoured, based on the development of building blocks which can be utilised in the existing informal market; and
 - a robust cost benefit analysis should be undertaken before committing to proceed with a development.
- 2.3 Many stakeholders expressed significant concern about the potential for pursuing a solution that was unnecessarily costly. Gas Industry Co is acutely aware of stakeholder sensitivity in connection with costs which may be imposed on the industry. In light of this feedback, Gas Industry Co embarked on a phased development of the platform bilateral option.

Wholesale Market Design Discussion Paper - September

- 2.4 More detailed work on the platform bilateral option was undertaken by the Gas Industry Co between May and August 2006, with significant input from the Wholesale Markets Working Group.
- 2.5 This work was presented to stakeholders in a Discussion Paper *Wholesale Market Design* released in September 2006.
- 2.6 That paper set out proposals in six main areas:
- the specific regulatory objective proposed for the work stream;
 - whether any arrangements were needed to facilitate longer term gas trades;
 - development of a standardised short term contract for use on a voluntary basis;
 - potential development of a trading platform for use on a voluntary basis;
 - treatment of prudential risk associated with blind trading on a platform; and
 - analysis of how balancing issues might change through time.

- 2.7 Nine parties, representing a broad cross-section of stakeholder interests, made submissions in response to these proposals.
- 2.8 The following section describes the approach proposed by Gas Industry for each main area, summarises stakeholder feedback on that issue, and sets out the current position of Gas Industry Co having taken the feedback into account.

3 Key Proposals

Specific Regulatory Objective

- 3.1 The Discussion Paper *Wholesale Market Design* recommended that the specific regulatory objective for this component of the wider wholesale work stream should be to facilitate transactional efficiency in gas trading. All but one submitter who commented on this issue supported the proposed objective, and that submitter considered that a better objective might be “the creation of a market structure where prices for gas reflect fair value that can be used as a reference for investment decisions”.
- 3.2 Gas Industry Co acknowledges that correct investment signals are an important consideration, but also wishes to ensure that prices provide appropriate signals for consumption and production decisions.
- 3.3 On this basis, Gas Industry Co affirms its support for the regulatory objective of facilitating transactional efficiency in gas trading.

Approach to Longer Term Trading

- 3.4 The Discussion Paper *Wholesale Market Design* set out a range of possible approaches to longer term trading (greater than one year), and concluded there was no case for introducing any formalised arrangements to improve transactional efficiency at this time.
- 3.5 It reached this conclusion because longer term trading tends to result in highly tailored contracts that do not lend themselves to standardisation through an organised trading arrangement. For example, such contracts will typically have quite specific provisions addressing reserves risk, price adjustment or escalation clauses, relief rights during force majeure events, etc.
- 3.6 Respondents generally supported Gas Industry Co's view, although some specific comments were made. These included:
- the exercise of market power could be an issue that reduces efficiency in trading;
 - Gas Industry Co could consider a bulletin board where parties describe their longer term requirements;

- there would be benefits in obtaining a higher level of transparency in respect of key terms, for example along lines of the EnergyHedge proposals in the electricity market; and
 - long term contracts could cross-reference industry model contracts for technical and gas delivery terms.
- 3.7 Gas Industry Co considered these points and noted that any market power issues arising from market concentration were outside its scope. Instead, Gas Industry Co is seeking to ensure that proposed arrangements do not enhance, and preferably constrain, any such power.
- 3.8 In relation to the bulletin board and increased disclosure comments, these appeared worthy of consideration to increase transparency. However, it appeared likely that the transparency benefits from a short term trading platform would be larger, given that longer term contracts are more likely to be highly tailored (e.g. treatment of reserves risk, escalation provisions etc), making disclosure of 'headline' terms less informative.
- 3.9 Given its finite resources, Gas Industry Co considers that it should continue to pursue the development of a platform designed to facilitate trading and consider other potential initiatives, such as enhanced contract transparency, once a short term platform is operational.
- 3.10 Lastly, the recommendation to allow importation of technical and other provisions from model short term contracts into longer term contract forms appeared sound. Gas Industry Co intends to make its model contract terms widely available, and parties entering longer term contracts will be encouraged to use them as they see fit.
- 3.11 Overall, Gas Industry Co concluded that there is no case at this time for introducing formalised arrangements to improve transactional efficiency for longer term (i.e. greater than one year) trading of gas.

Short Term Trading Contract

- 3.12 The Discussion Paper *Wholesale Market Design* recommended the development of a standardised short term trading contract for use on a voluntary basis. This is expected to facilitate trading by streamlining some of the processes involved in developing contractual terms to govern individual trades.
- 3.13 The Discussion Paper also appended a draft form of the proposed contract.
- 3.14 Respondents indicated general support for the development of standard contract – however, there was extensive and varied comment on the proposed terms of the contract. While feedback varied by issue, a recurring theme was that it would be useful to distinguish between a 'standard' contract that might be used without a platform, and a commoditised contract for use solely with a platform. The latter could not be varied by parties, and would be likely to be used for trades of relatively short duration (days/weeks). Accordingly it could adopt simpler terms.

- 3.15 Gas Industry Co supports this approach of distinguishing between the two different requirements, and is pursuing this in the next phase of work. A recent workshop made further advances in agreeing the terms for a standard contract for use without a platform and Gas Industry Co intends to convene another workshop in the near future with a view to finalising that standard contract.

Platform for Trading a Short Term Contract

- 3.16 The Discussion Paper *Wholesale Market Design* set out two broad options for a platform to support trading of a standard contract on a voluntary basis. They were:
- **Matching Platform** - development of a relatively simple platform that facilitates the matching of buyers and sellers, but leaves participants to make the arrangements necessary to execute and support a trade (such as transmission nominations, billing etc); and
 - **Trading Platform** - development of a more sophisticated platform that both facilitates matching of buyers and sellers, and automates the essential processes to execute and support a trade.
- 3.17 Because of its relatively simple functionality and self-contained nature, a matching platform would be less expensive to provide than a trading platform. However, it would also have less potential benefit because of its reduced functionality.
- 3.18 The Discussion Paper set out indicative estimates of the costs and benefits for each and, based on those estimates, recommended that it would be worthwhile proceeding with a matching platform and that work on a more sophisticated platform should not proceed at this time.
- 3.19 Submitters generally supported this approach in principle, though a number emphasised the importance of managing the process to minimise the risk of unexpected cost escalation. A number also felt that the potential benefits of a matching platform could be understated, relative to the more complex platform.
- 3.20 Overall, Gas Industry Co considers that there is a reasonable case for progressing a simple platform to facilitate trading, and will embark on this process.

Approach to Managing Prudential Issues

- 3.21 The Discussion Paper *Wholesale Market Design* noted that management of prudential risk is a key issue for a market operating on the basis of blind bids/offers (i.e. the identity of the bidder/offeror is unknown until a contract is formed).
- 3.22 The Paper proposed that the management of prudential risk for platform trading be dealt with through a 'whitelist' approach – in essence each participant would decide which other parties it would be prepared to deal with and, optionally, the maximum exposure it could accept and this information would be logged into the platform. Only trades meeting both parties' prudential limits would be matched.
- 3.23 The majority of respondents supported a whitelist approach – although some parties registered concern to ensure that it did not become an undue barrier.

- 3.24 Overall, the Gas Industry Co expects that the whitelist is workable, and will proceed on the basis that this is the preferred approach. Moreover, the whitelist offers a good deal of flexibility and, therefore, is regarded as superior to other options such as credit ratings and/or the requirement to lodge bonds.

Analysis of Balancing Issues

- 3.25 Although the Discussion Paper *Wholesale Market Design* recommended against developing a sophisticated trading platform at this time, it noted that such a platform could more easily allow trading very close to, or in, real time. The Paper also noted that the potential incremental benefit of any real time trading functionality was closely linked to the difficulty or ease with which physical pipeline balancing will occur in future, especially in the post 2009 era when legacy Maui gas is exhausted.
- 3.26 For this reason, the Paper recommended that work be undertaken to better understand the underlying physical issues involved in balancing in the future. In light of feedback, Gas Industry Co continues to regard this as an important matter, and intends to include it within the future work programme.

Other Issues Raised by Submitters

- 3.27 In the course of responding to the Discussion Paper, submitters also raised matters which were not formally part of the consultation process. Two issues in particular were commented on by multiple submitters:
- transmission capacity – when parties trade physical gas, they also need to be able to arrange for transmission service to ship the gas to a useful location. This is relatively straightforward on the Maui system because users can procure transmission services on a ‘spot’ basis. In contrast, some submitters considered that Vector’s current transmission arrangements may act as an impediment in some instances; and
 - exclusive supply arrangements – it was stated that some industrial Gas Supply Agreements (GSAs) have exclusivity clauses prohibiting the customer from purchasing gas from other suppliers – this was viewed as reducing the potential for certain parties to trade gas.
- 3.28 Gas Industry Co has discussed the transmission capacity issue in the *Gas Transmission Access Issues Review Discussion Paper*.¹ In essence, some parties believe the lack of a spot transmission product seriously inhibits trading on the Vector network. Conversely, others believe that the current ability to either relocate pre-booked capacity or trade capacity with another shipper generally provides the ability to obtain short-term capacity on the Vector system. While this is an important issue, resolution will ultimately be determined within the transmission work stream.
- 3.29 In relation to exclusivity clauses in GSAs, it is not possible to discern whether they reflect an asymmetry in bargaining power between gas sellers and buyers, or a

¹ Available on the Gas Industry Co website (www.gasindustry.co.nz) in the consultation section.

reasonable trade-off freely accepted *at the time* by the parties, but *subsequently* regretted by one party. The former would raise potential policy concerns, whereas the latter would not. The term and prevalence of such clauses is also difficult to discern. Furthermore, even if such clauses were to prove a significant barrier to trading, it is not clear whether Gas Industry Co has any authority or powers to override or alter the terms of GSAs.

- 3.30 In light of these factors, Gas Industry Co has concluded that it will seek further information on this issue, but that this should not delay the effort to progress wholesale market development.

4 Next Steps

Standardised Contract(s)

- 4.1 The goal is to complete the work on the standard GSA and make it available for use by industry early in the New Year. In particular, the focus is on resolving the issues outstanding in relation to liability and force majeure.
- 4.2 Gas Industry Co is also seeking amendment to section 41 of the Crown Minerals Act, which obliges petroleum mining permit holders who trade gas to obtain Ministerial consent. This requirement is a potential barrier to trading, and Gas Industry Co believes that the underlying policy rationale (maintaining integrity of the royalty base) can be addressed by other means.

Platform

- 4.3 As noted above, the risk of cost escalation is a major concern in relation to this element of the wholesale market work stream. For this reason, the work on the platform will be carried forward in the following stages:
- prepare a functional specification for a platform, incorporating input from the Wholesale Markets Working Group and other stakeholder feedback;
 - seek non-binding cost estimates from platform developers/operators based on the functional specification, in particular seeking information to enable any trade-offs to be made around functionality (e.g. service standards in relation to allowable downtime);
 - if necessary, amend the functional specification in light of information on expected costs;
 - finalise the specification and use it to obtain firm cost proposals from service providers and select a preferred provider; and
 - undertake final cost benefit assessment to inform a decision on whether to proceed.

- 4.4 In parallel with this work, Gas Industry Co will develop the detail of the implementation mechanisms, the form of the platform contract and the governance arrangements for a platform.
- 4.5 Assuming a final decision is taken to proceed with a platform, this would lead into the actual development process, acceptance testing and user training, with an expected go-live date in 2007/08.