

16 February 2007

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Dear Ian

Submission on Wholesale Market Design

Thank you for the opportunity to make a submission on the Gas Industry Discussion Paper "Wholesale Market Design", dated December 2006.

Contact continues to strongly support work on developing a low-cost platform to facilitate wholesale gas trading. We also support further development of the platform if use of the low-cost platform shows there is sufficient benefit to justify additional development expenditure.

We notice that the Gas Industry Company spent approx \$495,000 on consultation on wholesale market design in the 2005/06 budget year and has budgeted further expenditure of just over \$1 million to the end of the 2007/08 budget year. We have some concerns about the level of that expenditure given the estimate in the September 2006 Discussion Paper "Wholesale Market Design" that a high estimate of the cost of planning and consultation associated with a matching platform was \$550,000 and the high estimate of the present value of benefits associated with a matching platform was only \$1.65 million. We suggest the Gas Industry Company needs to carefully manage these costs to ensure the benefits of developing a matching platform are not lost.

To avoid further unnecessary costs we consider that the time has come for the Gas Industry Company to specify the detailed design of the platform and the cost of developing the platform based on that detailed design.

In order to minimize development costs we would expect the detailed design to be modeled on that of a similar platform that is operating satisfactorily. It also seems useful to evaluate whether the

proposed platform could be linked to or become part of an existing platform. An obvious example is the Energy Hedge trading platform. The following is a link to the website for that platform:

http://www.energyhedge.co.nz/ePublic/mtrade.mt_public.home

That approach should help the GIC to complete the development of the platform within the principles, identified by the GIC, of:

- simplicity;
- adoption of a conventional approach;
- locking in costs; and
- doing nothing if expected benefits do not exceed expected costs.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Alex Love', with a stylized, cursive script.

Alex Love

Contact Energy Limited Submission on Gas Industry Company Discussion Paper “Feedback on Wholesale Market Design” dated December 2006

Submission prepared by Alex Love, Contact Energy Limited

QUESTION	COMMENT
Q1: Do you agree that user pays is the preferred option for funding the establishment and ongoing operation of a wholesale market for gas? If not, what funding mechanism do you consider most appropriate and why?	<p>Contact supports the following approach to funding:</p> <ul style="list-style-type: none">• development costs and initial fixed operating costs recovered through a levy;• on going operating costs that vary according to participant activity charged to the participants responsible for the activity in accordance with a published methodology;• a published annual subscription fee payable for access to information generated from market activity;• a transparent budget established for all costs and revenues and actual costs and revenues monitored against the budget;• costs associated with resolving disputes recoverable from the parties to that dispute;• regular review, say annual, of the costs, revenues and method of recovery of costs.

Q2: Do you support the proposed approach to admission? If not, what alternative would you want and why?	Contact agrees with the simple approach outlined in the Discussion Paper, but in addition to an application from the organisation signed by an approved signatory and the provision of information on the standing of the applicant, we assume the applicant would have to sign an undertaking to abide by the rules of the matching platform and to pay charges for use of the platform. All existing users of the platform should be advised of every new admission before the new admission is able to use the platform.
Q3: Do you support the proposed approach to suspension? If not, what alternative would you want and why?	Contact agrees that a party's access to the platform should be suspended if that party fails to abide by the rules of access or fails to pay fees on time. This requires rules of access to be drafted.
Q4: Do you support the proposed approach to user controls? If not, what alternative would you want and why?	Clearly each party using the platform will need to control the ability of its representatives to commit to transactions through the use of the platform. Development of those controls should be the prerogative of each individual platform user.
Q5: Do you support the proposed approach to display of bids/offers? If not, what alternative would you want and why?	Contact would prefer the system to display all live bids.

<p>Q6: Do you support the proposed form of prudential criteria? If not, what alternative would you want and why?</p>	<p>There seems to be a number of options for establishing credit worthiness that include:</p> <ul style="list-style-type: none"> • financial limits; • volume limits; • rating agency credit ratings; and • third party guarantees. <p>Fixed financial and volume limits appear to have two problems:</p> <ul style="list-style-type: none"> • it will be difficult to ensure these continue to adequately reflect credit worthiness as a party's credit worthiness changes; and • fixed limits are very precise and may unnecessarily prevent trades e.g a trade valued at \$10 million may be allowed but a trade valued at \$10,000,010 may not be permitted. <p>The credit worthiness of a party will change as it takes on new commitments, relinquishes old commitments, its ownership changes and the business environment in which it operates changes. Most commitments are likely to be made outside the trading platform so that it will be difficult to make fixed credit worthiness criteria sufficiently dynamic and comprehensive to provide the required protection. To be meaningful credit worthiness needs to allow for all the changes in the financial position of a party using the matching platform, not just trades made by the party through use of the matching platform.</p> <p>It is difficult to envisage a party having access to the matching platform willingly reporting to all other users of the matching platform each change in its financial position to allow other parties using the matching platform to reassess whether they are prepared to trade with the party. Some further explanation of how the white-list is intended to work in practice is required.</p> <p>For larger traders, holding an acceptable credit rating may be a better approach to ensure credit worthiness. It is unlikely that smaller traders will be rated by a credit rating agency and some form of</p>
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	<p>third party guarantee is an option. Use of such prudential criteria is currently the standard approach of the industry. The MPOC provides an example of that.</p> <p>Financial limits rather than volume limits are appropriate for a party's purchases and sales. For example there appears to be more risk for a purchaser of gas if the seller of that gas defaults when the value of that gas is \$10/GJ rather than \$2/GJ. When gas has a high value the purchaser is likely to have fewer options for sourcing the gas than when the gas has a low value.</p> <p>Given the close link between trading and transmission arrangements and that both the MPOC and Vector arrangements require users of their pipelines to warrant title to gas and to meet minimum prudential requirements we wonder whether it is necessary for a users of a trading platform to meet prudential requirements in addition to the requirements of the MPOC or Vector under its TSAs.</p> <p>In addition it is worth considering further whether listed trading opportunities really must be anonymous. Listing the name of the party offering the opportunity to trade should overcome most of the problems associated with prudential requirements. We wonder whether the concerns about "opportunistic" behaviour and "collusive action to exclude new entrants" are real. The Commerce Act would seem to adequately address such issues.</p>
Q7: Do you support the proposed approach to adjusting prudential criteria? If not, what alternative would you want and why?	<p>This issue was touched on in the response to question 6. If parties are not allowed to amend prudential criteria they will set conservative prudential limits to address increased risk. That may unnecessarily hinder trades. It seems difficult to balance the need for trading anonymity with the need to manage trading risk. As the identity of the trading parties will be revealed to participants in the trade when the trade is consummated we wonder, as is indicated in the response to question 6, whether the need for anonymity could be relaxed.</p>
Q8: Do you support the proposed provision of an override? If not, what alternative would you want and why?	<p>The purpose of the matching platform is to encourage and facilitate trade. If a party wishes to relax or override its established prudential criteria that seems to be an issue that affects no one except that party. There does not seem to be any reason to hinder a party from relaxing or overriding its established prudential criteria.</p>

<p>Q9: Is your use of a platform likely to be significantly affected by whether the market operated on a blind basis or not? If so, in what way?</p>	<p>As indicated by our responses to earlier questions we are sceptical whether the advantages of blind trading are sufficient to offset the problems blind trading creates in managing credit risk. We find it difficult to understand why a trader's participation in the market would be hindered by the actions of other traders if that trader had gas to sell or wished to purchase gas at an attractive price. We are also sceptical whether identifying a particular party with an offer to trade gas would reveal anything of significance about that party to the market place or would disadvantage the party making the offer. The market place is likely to remain small with only a few parties actively using the matching platform. The position of the traders will be well known to the market place whether or not the identity of traders are revealed through the platform.</p> <p>Preserving the anonymity of traders using the platform appears to considerably complicate the design of the platform and will increase the cost of the platform. A possible approach is to implement a platform that requires traders to identify offers with the name of the trader and to test whether that inhibits trades. What is experience with other platforms?</p>
<p>Q10: Do you support the underlying philosophy in relation to the nature of the rights and obligations associated with a trade? If not, what alternative would you want and why?</p>	<p>Contact agrees with the underlying philosophy in respect of rights and obligations associated with trade. We note, however, the proposed approach assumes title transfer under the trade occurs at a point on the transmission pipeline and in particular the Maui pipeline.</p> <p>There is no reason why a block of gas could not be purchased up stream of the transmission system. But we imagine a prudent purchaser would want to know something about the delivery rate of that gas through nomination rights or through some other form of control over the extraction rate.</p>
<p>Q11: Do you support the proposed provision of buy and sell offers? If not, what alternative would you want and why?</p>	<p>Both buy and sell offers should be allowed.</p>

<p>Q12: Do you support the proposed use of 0.1 TJ/day as the basic trade unit? If not, what alternative would you want and why?</p>	<p>We agree that the basic time unit of trades should be a day, consistent with the basic time unit of transmission contracts.</p> <p>The basic unit of trades should be 1GJ. We think it unnecessary to fix a minimum quantity for trades if costs associated with offers and trades are correctly assigned. Correct allocation of costs should ensure offers are not sub economic.</p>
<p>Q13: Do you support the proposed ability to indicate whether partial acceptances will be permissible? If not, what alternative do you prefer and why?</p>	<p>Contact agrees that where a party is willing to accept partial acceptances that should be indicated in the offer. The underlying principle should be to encourage trades rather than to discourage trade through unnecessarily inflexible rules.</p>
<p>Q14: Do you support the proposal to adopt a virtual trading point? If not, what alternative do you prefer and why?</p>	<p>Contact does not see any advantage in adoption of a virtual point for trading. Now that displaced gas nominations are permitted under the MPOC any receipt point or delivery point can be used for trades although use of displaced gas nominations may incur additional transportation costs. It is unclear how use of a single point for trading increases liquidity. We note that MDL, as the pipeline operator, would probably take a keen interest in trades at a virtual point.</p>

<p>Q15: What sort of information would your organisation want from a platform for trading purposes?</p>	<p>Clearly the platform will need to provide information on open offers and in particular information on quantity offered, delivery rate, closing date for response to offer, commencement date of trade, termination date of trade, trading point and price. Provision of information on trading statistics such as volume traded within a fixed time period, say weekly, the average price paid in a week and the location of the trades would be useful although the cost of providing such statistics should be balanced against the benefit.</p> <p>Matters such as reconciliation and billing should be covered in the standard contract and should not need to be covered through the platform. The administrator of the platform would, however, need to provide billing for the use of the platform services.</p> <p>Replication of services already provided by OATIS or other industry arrangements is unnecessary and should be avoided. Since OATIS or Hedge Market already provide a trading facility it may be possible to adapt those platforms for wider trading.</p>
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<p>Q16: What sort of information would your organisation want from a platform for billing, reporting and governance purposes?</p>	<p>The only information required is confirmation of acceptance of an offer. As indicated in the response to question 15 billing should be covered by the standard contract. The platform administrator would need to provide billing for use of platform services. The administrator should regularly report the budget for operating the platform and costs incurred against that budget. Information would also need to be provided to cover operational issues such as the following:</p> <ul style="list-style-type: none"> • approval of the budget for operating the platform; • approval of changes to the platform operating rules; and • appointment of the platform administrator. <p>Information on offers not completed and the reasons for failure to complete would be desirable to help assess risks inherent in use of the platform.</p> <p>The rules covering use of the trading platform and the obligations of the platform administrator to users should be available through the platform.</p> <p>As indicated in our response to question 6 it is not clear to us how the proposed method of identifying credit risk would work.</p>
<p>Q17: What sort of information should a platform provide for general dissemination to stakeholders?</p>	<p>We agree that the information identified in paragraph 8.58 of the Discussion Paper should be available to those organizations that have access to platform services providing the benefit of access to that information exceeds the cost of making the information available.</p>