

20 December 2010

Hon Hekia Parata
Associate Minister of Energy and Resources
Parliament

Dear Minister

Gas wholesale market

I am writing to advise that the gas wholesale market trial is to be discontinued. Over the past several months an industry-led solution has been developed to the stage where it is expected to go live in early 2011. As this solution is an extension of the existing Balancing Gas Exchange, it is expected that it will be supported by gas industry participants.

Background

Both the October 2004 and April 2008 Government Policy Statements on Gas Governance (GPS) sought a short-term gas market to provide price transparency as well as to create an avenue through which parties with take-or-pay contracts could readily adjust their positions.

Gas Industry Co investigated options, consulted with the industry, and concluded that:

- an ad hoc market for trading already existed;
- such a market provided no price or volume information to customers or other interested parties;
- there was a degree of inefficiency due to the absence of a comprehensive price discovery mechanism; and
- industry demand for a formal wholesale market that would overcome these limitations was somewhat mixed.

Implementation of a trial market

Given our concern over the apparent information asymmetry and the mixed response from industry participants, Gas Industry Co determined that, before pursuing the creation of a formal wholesale market (as envisioned by the GPS), the first step should be to establish a low-cost electronic trading platform to provide a trial market. The features of the trial were:

- a simple electronic platform that would allow traders to post offers to buy and/or sell gas for periods from a day ahead up to six months in the future;
- contract-based market governance, so as to allow greater flexibility compared with formal rules under the Gas Act;
- bilateral trades between the parties, who would be responsible for their own invoicing and settlement functions;
- title transfer at a common point within the Maui gas pipeline, as it was a market for physical delivery (with the option to extend to other locations if demand warranted); and
- a “white listing” process through which participants could manage their risk exposure by limiting the counterparties with whom they would trade. This avoided the need to set arbitrary prudential requirements for the market.

Considerable input was provided by industry participants, including the selection and testing of the electronic platform and the development of the governance arrangements.

The market was made available to industry from June 2010, but the response has been disappointing. Only one industry participant joined the market, despite continued efforts by Gas Industry Co to encourage participation.

Outcome of the trial

The marked lack of interest among potential market participants could be due to a number of factors, including:

- increased industry acceptance of balancing charges;
- the balancing gas exchange (BGX) providing a form of price signalling; and
- lack of integration of the wholesale market platform with OATIS (due to the need to keep costs to a minimum).

In addition, section 41 of the Crown Minerals Act (CMA) is often cited by gas producers as a barrier to them participating in small volume trades. That section of the CMA concerns the requirement for producers to seek approval for each and every gas sale agreement. Each application costs \$1,000, which is a significant deterrent for deals involving small volumes (for example, the application fee for a 1,000 GJ deal could represent 10-30% of the sale proceeds).

Next steps

Although the ongoing costs of keeping the platform running are relatively modest, there does not seem to be any value in continuing to incur expenditure if the industry does not plan to support the trial market.

A recent development is that the MDL commercial operator is in the process of extending the functionality of the BGX so that it can accommodate bilateral trades between wholesalers. In the first instance this would provide the opportunity for those parties to make on-the-day trades between themselves. Given that the BGX has a degree of integration with OATIS, it is possible that such a market may find greater favour. It is also likely that the parties will have a somewhat larger budget for this activity compared with Gas Industry Co and, therefore, have greater ability to tailor the market to specific needs.

That this development has been able to be undertaken relatively quickly is largely due to the groundwork that was undertaken by Gas Industry Co. In particular, the creation of a "trading hub" within the Maui pipeline provides the basis for a system of title tracking which is essential in a market for physical delivery. As well, the market rules of the trial wholesale market that Gas Industry Co developed appear to have informed the rules by which MDL plans to operate the extended BGX.

Taking all of the above into account, Gas Industry Co considers it is logical to terminate the trial wholesale market at this stage. In the future, Gas Industry Co intends to confine this work stream to keeping a watching brief on the developments to the BGX.

I trust the above approach meets with your approval.

Yours sincerely

A handwritten signature in black ink, appearing to read 'James Bolger', with a stylized flourish extending to the right.

Rt Hon James Bolger, ONZ

Chairman

Copy: Carolyn van Leuven, MED