

21 August 2015

Commerce Commission
(via email to Keston.ruxton@comcom.govt.nz)

Dear Keston,

Re: Input Methodologies Review

1. This submission is made on behalf of the Major Gas Users Group (MGUG):
 - a. Ballance Agri-Nutrients Ltd
 - b. Carter Holt Harvey Pulp & Paper Ltd
 - c. Fonterra Co-operative Group
 - d. New Zealand Steel Ltd
 - e. Refining NZ
2. Members of the Group are significant users of natural gas. Collectively they consume about 25 PJ's per annum of gas or about 12% of the gas consumed in New Zealand.
3. Natural gas is used for energy and as a raw material for transformation. It is a preferred fuel because of its:
 - Low capital cost for utilities compared to other forms of energy (coal, biomass);
 - Lower operating cost and ease of operation;
 - Cleaner burning characteristics with lower emissions than coal; and
 - Ease of handling and consenting.
4. Most significantly members of the Group make up a significant proportion of New Zealand's productive sector (as exporters or in import substitution). They are energy intensive industries and delivered energy costs are a significant proportion of input costs. Supplies of competitively priced natural gas are therefore a key input to their operations.
5. We are grateful for the opportunity afforded by the Commission to participate in the recent Input Methodologies (IM's) Review Forum held on 29-30 July 2015 and present a major user perspective on our experience of the current DPP.
6. The next price reset for gas pipeline businesses is not due until May 2017. In the open letter of 27th February 2015 the Commission suggested there was benefit in combining the IM's for gas pipeline services so that consumers of these services would not have to wait until 2022 to realise the benefits of any changes. That seems sensible given the way that pipeline charges are tracking under the current determination.

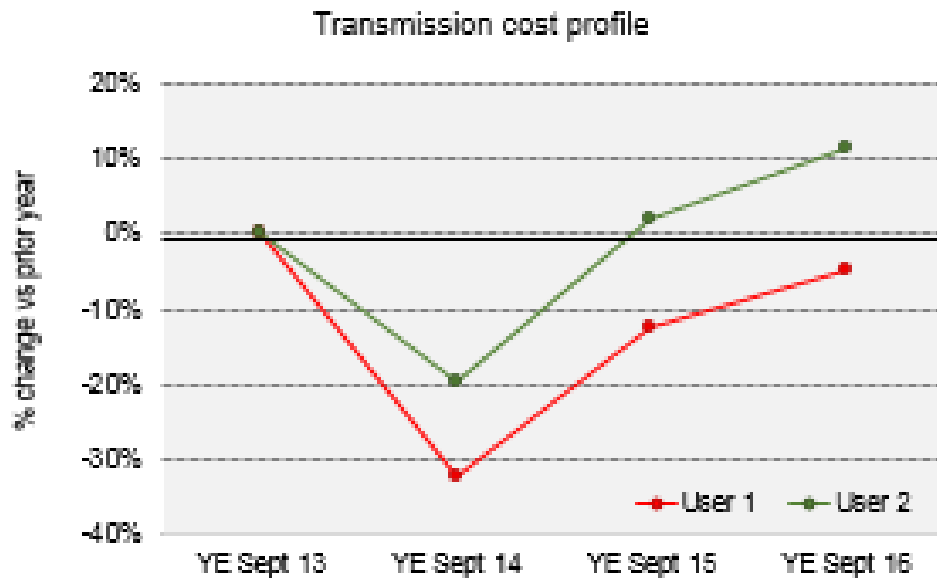
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7. Nevertheless we remain uncertain how various matters not specifically flagged in the Commission's June 2015 paper, but which to a greater or lesser extent impact the balance of risk between suppliers and consumers, will be considered in the IM review. Examples include:
 - quality standards (including for security);
 - cost inflation under the CPI minus X approach;
 - whether and how efficiency gains are to be passed through to consumers; and
 - incentives on pipeline owners to invest/innovate.
8. Our concerns with the existing IM's stem from our views that they seem to take a very static view of the regulation of pipeline businesses based on the assumption that the recent past is the best indicator of the future. As we will illustrate this assumption has turned out to not be the case under the current gas pipeline regulation.

Transmission charges

9. Largely driven by the dynamics of change in the electricity generation sector, the volumes of gas transmitted on the pipeline system to the Upper North Island has materially reduced in a material manner recently. The volume reductions have translated into higher user charges for the balance of gas that is sent through the pipelines. Our starting point for commenting on the definition of potential problems with the existing IM's is therefore to highlight the impact of these demand side changes on the costs of transmission in the three years since the initial default price path (DPP) came into effect.
10. For gas pipeline businesses the form of control is a revenue cap. In setting the initial DPP the Commission accepted that a revenue cap was appropriate where demand was generally not controllable by the pipeline owner. The pipeline owner's revenue is effectively 'guaranteed' and the risks associated with changes to demand, or from forecasting errors, was offset onto consumers. We attach the chart (presented to the July IM Forum) which provides an indication of two major user's experience of pipeline charges under the DPP to date.



11. The chart indicates the percentage change in transmission cost. The net result is that the significant reduction mandated by the Commission at the beginning of the regulatory period has largely been eroded and in reality has been quickly reversed. For Y/E Sept 2016 Vector provisional advice is that prices would increase on average by approximately 13%, noting that “this follows significant reductions in load on the transmission system”.
12. The reasons for this falling gas demand are assumed to be primarily the result of changing demand for thermal electricity generation on the Vector system (generation shifting from base-mid order gas plants to more peaking capacity closer to the gas supply location).

Risk allocation

13. We understand that pipeline owners set prices to derive allowable revenue based on two year prior demand (that is demand to Y/E Sept 2014). This process takes in the most 'recent' information and provides the owner with some certainty and continuity over time. With the announcement earlier this year by MRP to close Southdown, and recently by Contact to close their Otahuhu generation plant, declining demand for gas looks set to continue, and to be more significant than we illustrate above.
14. On the basis that the IM's continue to offset demand side risks on to consumers, we expect the trend of increasing gas transmission charges to continue – the important question for consumers is by how much? (we would note that gas transmission charges already comprise about 30% of the delivered gas price, depending on the energy component).

15. While we understand the current gas pipeline IM's were developed to limit possible monopoly behaviour of pipeline owners, the real time impacts of the form of control used suggests to us that consumers are bearing the bulk of the risks that the pipeline business faces. Furthermore, because of the demand side changes that are unfolding, gas consumers now face increasing uncertainty around the level of pipeline charges they may be exposed to in the future.
16. As consumers responding to this IM problem definition process, we question whether the allocation of risks under the existing IM's remains appropriate and especially whether the (guaranteed revenue) form of regulatory control is capable of providing the outcomes that are sought for the gas sector from economic regulation.

Bigger than a gas IM issue

17. The changes of demand for gas are coming from the changing demand patterns for thermal generation of electricity. Thermal generators are shifting to more of a peaking role, located closer to gas supply, while there is also a sustained trend to more local and renewable types of electricity generation. As Contact has noted in its press release confirming the closure of Otahuhu:

The role of thermal plant in New Zealand's electricity future is to support renewable generation and the growth of new technologies. This is best met by fast-start, gas-fired peaking power stations rather than large base-load plants.

18. These particular changes to gas demand on the Vector North system is a major shift that has occurred in a very short period of time because of some of the profound changes affecting the electricity sector (generation technologies) which are in turn prompting a detailed review of IMs in that sector.
19. Because of these cross sector influences, it is difficult for gas consumers to know how to define future scenarios and hence to provide some sort of scope to the potential for problems with and from the current IM's, especially when thinking about the appropriate allocation of risk between consumers and suppliers.
20. If nothing changes then our concern is that the current DPP will simply pass the regulated revenues through to consumers. But as major gas users we question whether changes of this significance can simply be allowed to flow through into regulated pricing without a profound examination of the form of control to consider whether:
 1. the current allocation of risk is appropriate going forward?
 2. any uplift over regulated WACC is appropriate going forward?

21. We recognise that there are two sides to the discussions that would take place around these questions. The objectives of Part 4 have an inherent tension between certainty for suppliers and benefits to consumers. When we experience changes such as this, these tensions will be tested and the previous trade-off will need to be reassessed. One of the concerns for us will be the approach that is taken to the evaluation of the industry structure and the efficiency levels that it operates at. How transmission assets are deployed and used underpins the reassessment.

Charging structures

22. When thinking about the form of control we question whether suppliers have gas access and charging structures in place that would encourage demand growth and help mitigate demand shocks. At the moment our view is that the pricing principles applied by Vector for the Vector North system heavily favour steady load over more variable types of demand. Because fixed charges are a very high proportion of Vector's tariffs there is, for example, less incentive for thermal generation using gas to locate close to demand.

23. As a matter of record, Vector's tariff structure has moved from a 60/40 fixed/variable split to now be a 90/10 split which does not encourage greater use of the pipeline where the demand could be peaky. The other matter that is concerning in this regard is the adequate transparency of supplementary agreements which, in our view, likely results in further residual price risks falling to the balance of consumers. We are unsure how the merits of a particular form of control (revenue cap or price cap) would be assessed as these are a complex mix of influences.

24. In summary our submission illustrates the impacts on major users of declining use of transmission, and challenges the allocation of risk. We note the Commission's observation at Para 110 that treatment of demand risk may reduce exposure to systematic risk, with knock-on effects on the regulatory cost of capital. If current risk allocation is not appropriate (we don't believe it is) then there should be a reduction in WACC.

Yours sincerely

A handwritten signature in black ink, appearing to read 'J. Hale', with a large, stylized initial 'J'.

Hale & Twomey/Arete Consulting Ltd
For the Major Gas Users Group