Tricia Jennings
Project Manager, Gas DPP reset 2017
Regulation Branch
Commerce Commission
PO Box 2351
Wellington
(via email to regulation.branch@comcom.govt.nz)

28 September 2016

Dear Tricia

**RE: Gas DPP reset 2017-Policy for setting price paths and quality standards for gas pipeline services.**

1. This submission is on behalf of the Major Gas Users Group (MGUG).It is in response to the Commission's paper of 30 August 2016 outlining its emerging views about various issues related to resetting the default price quality paths (DPP) that will apply to Gas Pipeline Businesses (GPB) from 1 October 2017. Nothing in this submission is confidential.
2. MGUG was established in 2010 as a consumer voice for the interests of a number of industrial companies who are major consumers of natural gas.
3. Membership of MGUG comprises:
    - Ballance Agri-Nutrients Ltd
    - Oji Fibre Solutions (NZ) Ltd
    - Fonterra Co-operative Group
    - Goodman Fielder New Zealand Limited
    - New Zealand Steel Ltd
    - New Zealand Sugar Company Ltd
    - Refining NZ
4. Our submission covers the following matters:
    a. Regulation
    b. Supplier scrutiny of forecasting expenditure
    c. Demand forecasting
    d. Standards for quality of service
    e. Effects of GasNet entry into the BOP.
5. Our submission is based on the Commission's paper but also anticipates and responds to some of the commentary and discussion from the Commission's public Q&A session of 14 September.

**Conclusions and Recommendations**

6. MGUG's conclusions and recommendations in this submission are:

    a. We remain concerned that regulatory WACC overstates supplier actual WACC resulting in higher prices and higher CAPEX investment than is economically efficient.
    b. We submit that suppliers should disclose more information about their cost of capital to the Commission.
    c. We support the Commission's proposed approach to supplier scrutiny of opex and capex forecasts.
    d. We recommend that the Commission investigates the use of supplier benchmarking measures outside of the DPP to incentivise opex reductions.
    e. We recommend that the Commission use supplier demand forecasts for forecasting constant price revenue growth.
    f. We support the Commission's proposal for an interruption standard as a quality measure.
    g. We support the interruption standard applying to GDBs as well as GTB.
    h. We recommend that the reporting trigger for GTB interruption is based on a critical contingency event under the CCM regulations, excluding events caused by upstream and downstream parties.
    i. We recommend that for GDB interruptions that a reporting obligation is based on appropriately defined High Impact events in supplier AMPs.
    j. For GDB interruptions we recommend in addition that a consumer appeal process should be able to act as a low cost and complementary approach to determining the need for a report and whether further audit or review of interruption reports is necessary.
    k. We recommend that the Commission adopt the Reasonable and Prudent Operator obligation as the test to apply to its assessment on whether supplier's acted prudently to prevent and mitigate an interruption event.
    l. We recommend that both suppliers and the Commission seek consumer input when reviewing AMPs.
    m. We are concerned that supplier competition in one region could flow through to higher prices in non-competing regions.
    n. We recommend that the Commission monitors pricing and price changes to ensure that suppliers are acting in the long term interest of consumers.

**Regulation**

7. When resetting the DPP starting prices based on current and projected profitability MGUG remains concerned that the Commission's building block approach to allowable revenue relies on a regulatory WACC setting that are not demonstrated to be reflective of New Zealand regulated suppliers.

8. Based on various evidence supplied throughout the IM work stream we maintain that there is a high likelihood that regulatory WACC settings systematically overstate the real WACC experienced by suppliers[1]. This means that starting prices will systematically build in a higher actual profitability for regulated industries. This practice is not consistent with the purpose of Part 4, particularly underlying principle that NPV should not exceed zero.

9. Although this appears to be outside of the scope of the DPP reset and a debate for IM determinations, the flow on effect of a biased estimate of WACC is through the price path determinations.

10. The risk of Part 4 being undermined is created largely from reliance on an imperfect CAPM model for determining cost of equity. This combines with significant information asymmetry between suppliers and consumers concerning the real cost of capital for suppliers with which to test the reasonableness of the regulatory WACC.

11. To address this information gap we consider that there should be scope for the Commission to require suppliers to disclose more information about their cost of capital[2].

12. This would assist the Commission in determining whether their current approach to estimation is reliable and reflective of actual supplier cost of capital. It also would guide the Commission in methodology refinement to give consumers greater confidence that excessive profits are not being earned in the long run.

**Scrutiny of opex and capex**

13. We support the Commission's approach to supplier scrutiny of opex and capex forecasts using supplier AMPs.

14. The quantitative and qualitative assessments of how suppliers' forecasts differ from a baseline "business as usual" expenditure appears to us to be a pragmatic and low cost approach to assessing whether forecasts are reasonable in context.

15. We support the principle vs prescription approach being taken to cost scrutiny. We accept that the Commission's underlying principle should be to reduce costs and complexity of its regime. Its proposed approach to scrutiny appears to us to be consistent with that principle.

16. A flexible approach might suggest a potential for regulatory scope creep of inquiry to suppliers. We don't see this as likely. A strong philosophy is more effective than prescription in ensuring good consumer outcomes. The Commission should have the flexibility to request a range of responses to satisfy itself on a particular issue of a

[1] Investment made vs profitability, RAB multiples, comments on actual financial structure
[2] actual cost of capital or alternatively, disclose key components such as their leverage and actual cost of debt from which feasible equity and asset betas can be determined and compared against comparator firms.

forecast. To the extent that this might amount to no more than a phone call or an email to clarify we consider this as consistent with a low cost approach.

*Why an asset quality standard is not sufficient assurance*

17. The suggestion was raised at the Q&A session that the Commission should be able to rely solely on a quality certification such as ISO 55000 as assurance that an expenditure forecast is also compliant. We do not agree based on our view on that ISO55000 and similar asset quality standards are not standards designed to meet the purposes of economic regulation. ISO55000 makes this clear[3].

*"This International Standard is primarily intended for use by:*

- *those considering how to improve the realization of value for their organization from their asset base*
- *those involved in the establishment, implementation, maintenance and improvement of an asset management system*
- *those involved in the planning, design, implementation and review of asset management activities; along with service providers*

*NOTE 2 This International Standard does not provide financial, accounting or technical guidance for managing specific asset types."*

*CAPEX scrutiny*

18. MGUG remains concerned that regulatory WACC systematically overestimates suppliers' actual WACC. Aside from affecting starting prices this also potentially leads to inefficient CAPEX[4] as suppliers have incentives to increase their RAB. We believe that this risk is inherent in all CAPEX including those that fall within BAU.

19. We do not propose that this necessarily requires scrutiny of every routine CAPEX item. We do think it would be prudent to have an awareness of this risk when considering expenditure forecasts and that appropriate judgment is exercised on whether to apply further scrutiny.

*Ratios as further guidance*

20. The use of ratios on BAU variance checks should be extended to provide further information to consumers on prudent expenditure by using benchmark ratios as a to compare performance between suppliers.

21. We understand that the Commission is restricted in its ability to benchmark performance between suppliers around its legislated processes such as default price path setting. However we don't believe that there is any legislative prohibition on benchmarking for public and other stakeholder interest purposes.

[3] https://www.iso.org/obp/ui/#iso:std:iso:55000:ed-1:v2:en

[4] Early investment, higher cost.

22. Such benchmarking would provide further consumer insights as to whether one supplier is outperforming another and whether the reason for that is something that could be used to encourage downward pressure on prices. Suppliers are not in direct competition but are incentivised to reduce costs. We therefore see such benchmarking as being beneficial to both suppliers and consumers.

23. We would suggest that the Commission should look at identifying ratios that might enable direct comparisons between suppliers outside of legislated processes. We have not investigated what those ratios should be but the concept is to create valid comparisons between different suppliers[5]. This might encompass the different expenditure categories relative to e.g.: number of ICP; inch.km of lines; ICP density; GJ transported/km; $ RAB etc.

**Forecasting constant price revenue growth**

24. We appreciate the Commission's desire for an incremental approach to making changes as to how it sets the DPP but we believe that it should not separate revenue and expenditure forecasting basis.

25. We disagree with the Commission's view that its current approach to forecasting CPRG is lacking any evidence that it is not fit for purpose. MGUG has detailed its concerns with the methodology in a submission under the IM work stream[6] which we also allude to in our discussion below.

26. The demand forecast approach outlined via the Concept report acknowledges the limitations of its methodology. Concept notes that an econometric approach is not feasible and instead elects to default to a structural demand approach. This is not because the structural approach is demonstrated to be more accurate, but rather because of "expected logical relationships." This is not a criticism of Concept's work, but to rely on it to set a price path when not linked to the expenditure forecast is an unnecessary and flawed approach when compared to the alternative of using supplier forecasts.

27. If the Commission is proposing to allow suppliers to supply their expenditure forecasts, a position that MGUG supports, then the Commission should rely on supplier demand forecast that drive their expenditure forecasts. Independent demand forecast are inherently unreliable as well as being asymmetric from supplier demand forecasts. As a consequence an independent demand forecast is less likely to be internally consistent with the supplier expenditure forecast.

28. The supplier approach to forecasting may have no stronger basis than an independent one but its superiority is two-fold. Firstly it captures what an independent forecast can't,

[5] Suppliers already have a lot in common including business model and products and services. Adjustments are required to account for scale.
[6] MGUG Submission on IM review draft decision – 4 August 2016

i.e. the supplier's asymmetric knowledge of its business including growth prospects. Secondly it will also be internally consistent with supplier expenditure forecasts since expenditure and revenue are closely correlated.

29. Using a supplier based demand forecast should also assist opex/ capex scrutiny. The forecast can provide information relevant to questions about levels of expenditure that reduces scope and hence cost for further scrutiny i.e. if expenditure looks high, an explanation might be found from the growth forecasts.

**30.** Our recommendation is that the Commission minimises information asymmetry and aims for internal consistency where it cannot expect to achieve forecast accuracy. The Commission can use similar controls as for expenditure to check for demand forecast reasonableness[7] .

**Setting Standards for quality of service**

31. We are supportive of the Commission's proposal to introduce a new major interruption quality standard.

32. The interruption quality standard is a more meaningful standard than Response Time to Emergency (RTE) for consumers for gas transmission services. It appears to have broad support from transmission service providers as well as consumers. To that extent we expects no disagreement regarding the introduction of an additional standard for transmission services.

*Why an interruption standard should also apply to GDBs*

33. During the Q&A, there was a question whether an interruption quality standard should also apply to GDBs[8]. Although MGUG's initial focus was primarily around the inadequacy of the existing RTE measure for GTBs we see valid reasons for why the new measure should also apply to GDBs. This is for the same reason as to why it should apply to transmission services, i.e. asymmetric consequences of failure.

34. Like GTBs, whilst there is a general alignment between consumers and suppliers on achieving reliability, the cost of failure of reliability can be higher for consumers. This creates different expectations around what is efficient expenditure to ensure reliability.

35. For example, economic losses to distribution connected industrials[9] reliant on gas for process heat is likely to exceed GDB revenue losses and repair costs. There are also wider social, safety, and health externalities arising from temporary loss of consumer energy source to provide heating and other services for homes and public facilities such

[7] Up to including an independent forecast as a check.
[8] The valid question was whether a problem existed with the current measure.
[9] The Auckland industrial market is around 6 PJ pa including large users such as OI glass, NZ sugar, OJI, Pacific Steel, Fonterra. The Bay of Plenty distribution system similarly services large industrials including includes paper mills and dairy processing.

as hospitals. Outages can also lead to lengthy restarts further increasing disruption costs if networks fall below minimum pressure[10].

*Should GDBs be required to report if outage was a result of a GTB outage?*

36. It follows from the reasoning for adopting the interruption standard that GDBs would be required to report to the Commission if an interruption arose from a GTB event. Although outside of a GDB's control it still requires them to act prudently to mitigate effects[11].

*Interruption Standard Reporting Threshold*

37. MGUG proposed prescriptive measures on number of major outage events and also impact mitigation.[12] The Commission has instead proposed a reporting requirement and allowed itself the flexibility to investigate whether a GPB acted prudently.

38. This approach would be consistent with MGUG's underlying intent and we support the Commission's principle approach over our suggestion to more closely prescribe reliability outcomes.

39. We do see some practical difficulties in creating stakeholder legitimacy for an assessment of materiality and prudency. These include defining what constitutes a major interruption to trigger such a report and defining what constitutes as reasonable prevention and mitigation measures.

40. For GTBs a curtailment declaration by the CCO as a result of a pipeline failure provides an obvious and neutral threshold for reporting. This by definition also exempts curtailments created by upstream welded parties and also situations where curtailments are necessary as a result of downstream activity (e.g. congestion management in peak periods)

41. The reporting trigger for GDBs is less clear cut but the principle of it being created from a High Impact event might provide a useful starting point. The Commission could be guided by GDBs AMP identification of such events to determine the appropriate reporting threshold[13]. Possible further assessment measures include time (minutes) x volume (GJ) with number/ proportion of ICPs affected. This would allow for both duration and size of the parties affected to set a materiality threshold[14].

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[10] Domestic connection needing to be purged and tested to ensure that oxygen in lines has been displaced.

[11] A GTB event is also recognised as a High Impact Low Probability even in Powerco's AMP for gas.

[12] We proposed that the target for major outages as measured by critical contingency events under CCM regulations should be zero, and where the outage was created by events outside the direct control of pipeline owners that the length of the outage should not exceed 48 hours.

[13] Although we would note that HILP events can be too narrowly defined as in e.g. Powerco's case where HILP is limited to natural disaster, transmission outage, and safety (fire and explosion), but not customer economic impacts.

[14] For example a complete loss of gas to NZ Sugar in Auckland (1 ICP) is about 5% of total network demand. The equivalent number of households for this level of demand is about 30,000.

42. For GDBs where curtailments are not being managed through an independent operator such as a CCO, and where a GDB might dispute whether a reporting threshold was met we would support a consumer appeals process to assist the Commission in its decision. This would allow affected consumers to put a case to the Commission that an impact should have been considered as high impact requiring a report to the Commission. The Commission could then make an assessment on whether a report is required.

*Prudency Test*

43. Regarding the standard of performance to which GPBs might be held when considering whether the interruption should lead to prosecuting S87, we suggest adopting the legal concept of Reasonable and Prudent Operator (RPO) obligations as a test.

44. RPO obligations are frequently applied in commercial contracts in the oil and gas industry to specify the standard at which a party must perform an obligation or set of obligations. Typically it worded as follows:

> *"a Person seeking in good faith to perform its contractual obligations and, in so doing and in the general conduct of its undertaking, exercising that degree of skill, diligence, prudence and foresight which would reasonably and ordinarily be expected from a skilled and experienced operator engaged in the same type of undertaking under the same or similar circumstances and conditions"*[15]

45. The RPO wording has an accepted legal interpretation under English legal systems including in New Zealand. Adopting this also enables judgment on the particular circumstances of a case. This is consistent with the Commission's general approach to low cost regulation.

46. The trade-off of with a less precise definition of a standard to determine whether it has been breached is that it becomes potentially more costly to prosecute a case when it is disputed. We see this risk as symmetric meaning both parties are equally incentivised to avoid lengthy and expensive litigation.

47. An advantage of adopting the RPO test is that it doesn't impose unreasonable expectations on a supplier to provide a level of reliability greater than others would be expected to provide under similar circumstances. Consequently there is no incentive to invest in prevention and mitigation measures beyond what is "reasonable" under a legal definition. Because it is a standard and understood commercial term, it introduces no further risk for suppliers under typical commercial agreements.

[15] Eg http://energylegalblog.com/blog/2015/11/13/what-constitutes-reasonable-and-prudent-operator

*Purpose, contents, and review of the report*

48. MGUG is supportive of the Commission's proposal for the contents of the interruption report.

49. We think that an interim report should be released earlier than six months. The interim report should outline the timeline of events, an initial assessment of consumer impact, actions taken, and next steps to complete the investigation and report. We would recommend that the interim report should be made available to the public within two months of the event in order to ensure that all affected parties are being referenced in the investigation.

50. We favour a full and transparent public disclosure of the interruption report with an invitation for parties who consider themselves to have been affected to make further submissions on it. This would act as a low cost independent review whilst maintaining the Commission's discretion to seek further advice.

*Near Miss Reporting*

51. We believe that near miss High Impact events provide useful leading indicators and valuable lessons to strengthen preventative measures to reduce interruption risk. We do not consider it necessary that suppliers be required to report on these under DPP quality measures but do consider that there should be visibility and transparency around these events to provide further assurance to consumers that suppliers are acting prudently.

52. We would envisage that near miss events form part of risk dashboard in AMPs.

*RTE*

53. We have no clear preference for retaining Response Time to Emergencies (RTE) as a quality measure. To some extent a response time for major interruption events is an inherent part of the interruption reports and can be subjected to a prudency test.

54. We are not clear whether consumers find RTE meaningful. For example it relies on the supplier response time once it has been informed of an emergency rather than when it actually occurred. RTE also says nothing about the quality of the response.

*Other quality measures*

55. MGUG agrees with the Commission that it is not necessary to include pressure, specification, and odourisation events within the quality mechanism. Our reasoning is not that these are outside of GTB control[16], but rather that these matters can be dealt with more effectively under pipeline access codes.

[16] GTBs degree of control is exercised by their ability to set the conditions for interconnection agreements including specification and monitoring. Their ability to manage product specification is contractual and should be backed by auditing compliance with the monitoring standards of interconnection agreements.

*High Impact, Low Probability (HILP) risk and AMPs*

56. We broadly agree with and support the Commission's discussion in Attachment E on HILP risk and its outline of consumer concerns. We also support that a more quantitative risk assessment is both warranted and feasible to meet these concerns.

57. We caution that HILP events should not be limited to events that are only outside of supplier control. For example Powerco's AMP which is highlighted as being the most comprehensive in terms of identifying HILP risk, limits these events to just three scenarios (gas transmission failure, undetected gas escape into a building leading to a fire or explosion, and long term loss related to natural disaster)[17]. This is unnecessarily restrictive in its definition of high impact which can also arise from other sources such as; corrosion, third party damage, incorrect operation, equipment failure, and construction standards.

58. We agree with the Commission's comments in Appendix E para 9 (repair times and exposures at each high risk location) and believe that this type of information should be contained in the AMP.

59. We are encouraged by supplier willingness to engage with consumers in both the AMP content in general and risk identification and management in particular. We would encourage suppliers to run effective stakeholder engagement processes as part of their input into annual review of their AMPs.

60. We would similarly encourage the Commission to include consumer views in their periodic assessment on the effectiveness of AMPs.

**GasNet expansion into BOP**

61. MGUG is concerned that GasNet's expansion into the Bay of Plenty may lead to price increases in regions where suppliers are not competing.

62. This is a potential issue when pricing methodology under the Act and regulation are not prescriptive and allow suppliers to price discriminate freely between regions as well as customers within the overall revenue or price cap.

63. Such behaviour is observable where a regulated supplier is competing with Nova's private network. Prudent discounts being offered in these situations are being paid for by consumers who don't have the benefit of a competing offer[18].

64. If such price discrimination occurs as a result of GasNet entering the Bay of Plenty it would be observable through different price structures for the same load groups.

[17] Gas AMP 2015, 3.3.3.1 http://www.powerco.co.nz/uploaded_files/Publications-and-Disclosures/New/Disclosures/Gas-AMP-2015.pdf

[18] There is no guarantee that the prudent discount is in fact "prudent" since lost revenue is always recoverable irrespective of discount size.

65. The Commission seems to rely on the logic that this is unlikely to occur because suppliers are naturally incentivised not to increase prices because gas is a discretionary fuel.

66. In some cases and circumstances gas is not discretionary – e.g. NZ Steel, Ballance, and Methanex where gas is a direct input into the product. Gas is also not discretionary in the short run and the assumption that it is discretionary assumes both suppliers and consumers take a long run view.

67. That fact that a short term rather than long term view can be taken by suppliers was evidenced by MGUG members' experience through price realignments after closure of Southdown and Otahuhu B on the Vector transmission system. Not only was pricing impact different between individual firms depending on whether they had standard or non-standard agreements, but also between pricing regions for standard agreement users.[19] Given that both systems were sold by Vector and MDL to First State Investments this explains why long run consumer interests might be compromised by suppliers with shortened investment horizons.

68. Although it appears less likely that current ownership might be less than long term, persistent and sharp price discrimination changes may provide a useful indicator that long term consumer benefits are not being taken into account.

69. We would encourage the Commission to monitor pricing changes in general, including the GasNet/ First Gas dynamic in the BOP, to ensure that the long term interests of consumers are being protected.

Yours sincerely

Len Houwers
Aretê Consulting Ltd
<u>Secretariat for the Major Gas Users Group</u>

[19] For example Otahuhu B and Southdown were consumers in the Auckland pricing region. After their closure a mismatch between cost and revenue allocation in pricing regions developed with costs exceeding revenue for Auckland with the deficit allocated to other pricing regions.