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24 March 2017

Dear Tricia

**RE: Cross Submission Gas DPP 2017-Draft Reasons Paper 10 February 2017.**

1. This cross submission is on behalf of the Major Gas Users Group (MGUG). It is in response to submissions made by Suppliers on the Commission's paper<sup>1</sup> of 10 February 2017. Nothing in this submission is confidential.
2. MGUG met with First Gas' GM Commercial and Regulation, and Asset Manager on 23<sup>rd</sup> March to get clarification on points raised in First Gas' submission. This was in order to better inform MGUG's position in this cross submission process.
3. Our submission covers the following matters raised by First Gas in their submission<sup>2</sup>:
  - i. Transmission Asset Replacement and Renewal (ARR)
  - ii. Distribution system growth and customer connection capex
  - iii. Cap on average price increases.
  - iv. Quality Standards

**Downward adjustment to First Gas Transmission own expenditure forecast.**

4. As consumers MGUG has an interest in First Gas acting reasonably and prudently as an owner and operator of a key piece of infrastructure that supplies energy to New Zealand businesses. We interpret this RPO standard to be equivalent to the Commission's standard of Good Industry Practice (GIP).
5. As noted in our earlier submissions on quality measures the consequences of gas interruption due to integrity failures are likely to have an asymmetric effect on

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<sup>1</sup> Default price-quality paths for gas pipeline businesses from 1 October 2017 to 30 September 2022 Draft Reasons Paper

<sup>2</sup> First Gas – Submission on Gas DPP draft decision – 10 March 2017

consumers. Hence we place a high value on security and reliability of the gas transport system.

6. MGUG supports First Gas' position that the Commission appears not to have accepted Strata's findings and advice on First Gas' transmission CAPEX for ARR.

7. Strata noted in its assessment of First Gas's expenditure forecast for CAPEX that<sup>3</sup>

*23. Supplier evidence assessment is not required. However, due to the materiality of the expenditure, the Commission may wish to consider requesting the relevant business cases for the Gilbert Stream and White Cliffs remediation projects for further assurance.*

*24. Notwithstanding the above, **all questions on capex were satisfactorily addressed in the AMP evidence assessment and no matters require supplier evidence assessment***

8. The Commission has decided not to accept the increase in the ARR category and to use its fall back calculation based on historical spending. This is notwithstanding that Strata accepted the reasoning for increased CAPEX other than White Cliffs (a CPP application) and Gilbert Stream (further justification required).

9. We find First Gas' reasoning for increased ARR above historical (separate from justifications for White Cliffs and Gilbert Stream projects) plausible, i.e. that the previous owner's incentive for deferring ARR may have been influenced by reduced investment time horizons related to a decision to divest.

10. We understand that First Gas has developed its ARR investment program as an output from a risk assessment process as part of the application of the standard AS/NZS 2885 Pipelines - Gas and Liquid Petroleum, within the context of their intended long term investment in the transmission system. We consider this as GIP and also aligned with consumer long term interest in the security and reliability of the transmission system.

11. Notwithstanding our support in principle of First Gas' submission that its ARR forecast is prudent we are not in a position to assess whether the quantum and timing represents efficient investment. The supporting information in Table A of First Gas' submission<sup>4</sup> AMP takes a largely qualitative and subjective assessment of risk across broad categories of expenditure and is not linked to any measures of security and reliability that appear to drive the investment program.

12. First Gas has in support of its submission detailed the conclusions of its commissioned expert Chris Harvey. We note that in general his conclusions on prudent ARR expenditure are consistent with Strata's assessment.

13. We anticipate that First Gas will spend what it feels it must to maintain system integrity to retain its AS2885 certification. This would be in spite of disallowed CAPEX. In turn this

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<sup>3</sup> Gas DPP Strata BAU Variance Check and AMP Evidence First Gas Transmission 16 November 2016.pdf

<sup>4</sup> Ibid – pp 6-7

would rely on First Gas recovering the actual expenditure in the next price reset. However this approach would not be supportive of the Commission's revised intention to rely on supplier forecasts supported by reasonable explanation.

14. Our conclusion is that we would support a review of the Commission's decision to disallow the forecast ARR expenditure with a view to accepting First Gas' argument that this expenditure is necessary to avoid compromising security and reliability standards of the transmission system.

#### **Distribution Growth and Customer Connection Capex**

15. MGUG appreciates First Gas' commitment to grow its distribution network. This is consistent with MGUG's philosophy that a wide and diverse participation in the gas market keeps cost of service low for consumers.
16. First Gas' optimism for growth in the North Island distribution system that it owns appears at odds with the previous owner. Nevertheless the example of GasNet stepping in to fund a subdivision development in Papamoa, a network associated with Vector North Island Distribution, is illustrative of the different commercial drivers of the previous owner.
17. We are unable to respond quantitatively to the justifications for contingent projects not accepted as justified by Strata other than to note that the growth projects put forward by First Gas appear to be typical of organic growth opportunities on an existing network.

#### **Cap on average price increases**

18. In the current regulatory period consumers on posted price terms on the Vector transmission access regime were subjected to price increases of +25% and +23% in 2015 and 2016. This was a result of customers on standard pricing absorbing losses of revenue from special agreements including through the closure of Otahuhu B and Southdown power stations. This pricing volatility was a result of the contracting approach taken by Vector over time and their pricing methodology. Whilst pricing conformed to the pricing principles the result created unequal outcomes between different consumer price categories in order to insulate Vector from revenue volatility.
19. MGUG is therefore supportive of the Commission's proposal to cap average price increases at 10% as a response to discouraging similar outcomes in the new regulatory period.
20. We note that First Gas' submission is to support the intent of stable prices but to argue that a cap on average price increases may be detrimental to the development of the new access arrangements currently being designed.
21. We note that First Gas puts some weight on the ability of customers and the GIC to effectively veto a pricing regime that is not supported by industry<sup>5</sup>

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<sup>5</sup> Ibid – p12

*The Commission can take a significant degree of comfort from the extent of customer input and regulatory oversight from the Gas Industry Company (GIC) in the process of developing the new access code. **The ability for First Gas to implement a pricing regime that is not supported by our customers and industry regulator is remote.***

Whilst we appreciate First Gas' desire to find consensus with industry participants on the development of the code, and engagement to date has been positive, we disagree with their statement. It has been made clear throughout the process of redesigning the new access code that First Gas has a commercial prerogative to develop a code that supports its interest as asset owner. Industry, whilst it is being actively consulted, does not vote on the adoption of the code. Similarly the GIC's ability to veto rests only on its statutory powers to assess whether the code meets regulatory objectives under the Gas Act and the Gas Policy Statement (GPS). Its regulatory powers do not extend to regulating pricing.

22. First Gas provide a hypothetical worked example in its submission to demonstrate how it might breach the 10% increase cap<sup>6</sup> with just two standard products; Daily Nominated Quantity (DNQ) and Priority Rights (PR). The worked example assumes that revenue from PR will be significant and volatile, i.e. of the order of 5-30% of total revenue. It also assumes that wash-ups as a result of year to year forecast errors will be substantial (-5% to +10%). There is no support for this level of materiality and volatility. More likely scenarios of lower contribution and volatility would suggest that the 10% level would not be breached.
23. The hypothetical example also doesn't distinguish between special and standard arrangements which will continue to be a feature of their commercial arrangements with customers – ie DNQ and PR revenues may be underpinned by different commercial arrangements depending on the customer.
24. Whilst we appreciate First Gas' concern for avoiding unintended outcomes from a code that has yet to be designed we would be reluctant to find consumers facing similar outcomes as experienced in the current period where price volatility is defaulted to standard customers in order to give price stability to favoured customers.
25. Our assessment is that a price increase cap provides an appropriate incentive to avoid ad-hoc agreements and improve demand forecasting.

#### **Setting Standards for Quality of Service**

26. First Gas proposes a redefinition of "major interruptions" to exclude curtailments from Band 2 on the basis that these are large consumers (greater than 15TJ/day) who would be logically curtailed first<sup>7</sup>.

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<sup>6</sup> Ibid – p46

<sup>7</sup> Ibid – p42

27. This redefinition would exclude interruptions to Ballance, one of MGUG's members. We see no basis for excluding band 2 from the Commission's definition of major interruption simply because these consumers happen to have a greater demand for gas or because they happen to be few in number. A gas curtailment on Ballance's facility not only creates stress on its equipment through the process cycling curtailment involves in disrupting its steady state operation but also has significant commercial impact precisely because of its scale.
28. The intent of the quality standard is to ensure appropriate incentives to provide a minimum level of service demanded by consumers. Adequate carve outs have already been acknowledged by the definition to avoid items that are clearly outside of the TSO's control. We see no need or basis to further dilute the provisions.

Yours sincerely

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

Richard Hale/Len Houwers  
Hale & Twomey Ltd/Arete Consulting Ltd  
Secretariat for the Major Gas Users Group