hale & twomey

ARETÊ CONSULTING LTD

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Commerce Commission
P O Box 2351
Wellington

Dear Paul

Re: Setting of Starting Prices for Gas Pipeline Businesses under the Initial Default Price Quality Path - Commerce Commission Discussion Paper dated 22 August 2011

1. This following submission is being made on the Commerce Commission Discussion Paper dated 22 August 2011 by Hale and Twomey/Aretê Consulting Ltd on behalf of the Major Gas Users Group:

    a. Fonterra Cooperative Ltd
    b. Carter Holt Harvey Ltd
    c. New Zealand Steel Ltd
    d. New Zealand Refining Company Ltd
    e. Ballance Agri-Nutrients Ltd

2. MGUG was established in 2010 and has as one of its aims the promotion of effective/efficient market arrangements for delivery of natural gas. As such we welcome the opportunity to comment on the principles for the setting of the starting prices for gas pipeline businesses under the Initial Default Price Quality Path as members of the group are substantial users of gas and will be directly impacted by the regulatory instruments being developed by the Commission for suppliers of gas pipeline businesses. While these views are expressed to be on behalf of the group we note that members may have individual views on matters contained within this submission which they may choose to provide to the Commission directly.

3. Our views are targeted at Gas Transmission Businesses (GTBs) as MGUs have mainly direct connections to transmission rather than distribution networks.

We make three main submission points:

    a. We support the Commission's approach that the starting prices for a DPP should be determined by the Commission based on the current and projected profitability of each supplier.

b. We think that the Commission should consider a weighted average price cap as the preferred form of control on Vector's GTB.

c. With respect to information required to set starting prices we form the view that the role of the Commission is to provide a reasonableness check on GTB's routine budgeting processes rather than to also prescribe methodology for projecting revenue, opex, and capex.

4. Section 2: The Role of the Initial DPP and Starting Prices for GPBs.

a. Our members have in the past expressed concerns about lack of timely investment in infrastructure and questioned whether a fair price is being paid for the services that are being delivered. We support the purpose of Part 4 of the Act and attempts at methods to achieve its intended outcomes.

b. We agree with the Commission that the starting prices for a DPP should be determined by the Commission based on the current and projected profitability of each supplier (Section 53P(3)(b)) in terms of meeting the purpose of Part 4 of the Act. The alternative approach of assuming the prices that applied at the end of the proceeding regulatory period risks either having insufficient incentives to invest/ innovate by GPBs, or fails the test of sharing the efficiency gains, including lower prices with consumers.

5. Section 3: Proposed Approach to Setting Starting Prices for GPBs

Form of Control for GPBs

a. We have noted the Commission's view that GTBs, including Vector, should operate under a Total Revenue Cap. We have also noted Vector's shift in position regarding the most appropriate form of control for its GTB from a weighted average price cap (WAPC) to a total revenue cap (TRC). The Commission outlined its reasoning for TRC vs. WAPC in terms of promoting the purpose of Part 4 in earlier discussion documents[1] which we use here to suggest that under Vector's current pipeline regime, the purposes of Part 4 may be better served by a WAPC form of control than a TRC.

A key reasoning presented by Vector is that it is subject to significant demand risk over which it has no control. This is a reasonable assumption for MDL where revenues are exclusively variable and demand can fluctuate significantly depending on whether Methanex has a contract or it is a dry or wet year for

[1] Initial Default Price-Quality Path for Gas Pipeline Businesses – 1 April 2011.

generators. But the Vector form of contract carriage is largely immune to these fluctuations despite Vector's concerns outlined in their submission[2]:

i. *Reliance on small numbers of large customers entering/ exiting the market.*

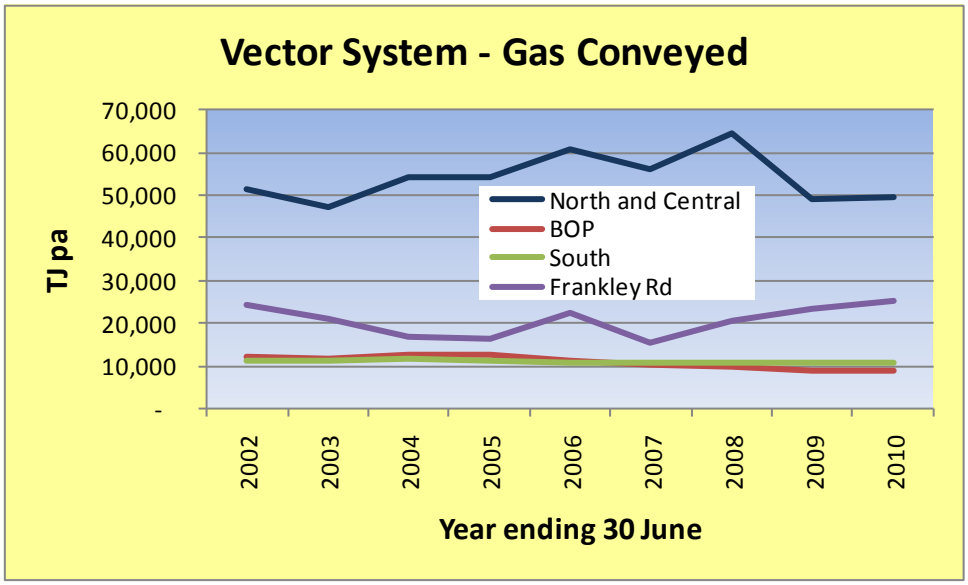
ii. *Lack of negotiating power for non-standard contracts.*

iii. *"Significant factors" driving demand beyond Vector's control.*

Our observations would be that "large customers" tend to be stable customers as they generally have long term commitments in their invested capital and don't suddenly switch from or to gas, certainly not over the timeframes contemplated for the regulatory periods.

Furthermore Vector's revenue is often assured by these large customers through nonstandard terms. Electricity generators, responsible for most of the annual fluctuations in demand, for example are subject to a fixed capacity fee only so that Vector's revenue is fixed regardless of how much gas is used by them[3].

Secondly although demand is undoubtedly dynamic in aggregate, demand patterns are remarkably stable as the figure below demonstrates.



Source: Vector Financial Disclosures

[2] Vector Submission on the Commerce Commission's Initial Default Price-Quality Path for Gas Pipeline Businesses: Discussion Paper -27 May 2011. Executive Summary

[3] Disclosure of Gas Prescribed Agreements-Non Standard Gas Transmission Agreements. Contact's Otahuhu B and TCC Plant appear to be on fully fixed fees for capacity reservation (no variable charge). Unless Contact de-rates current equipment MDQ requirements are unlikely to change regardless of amount generated each year.

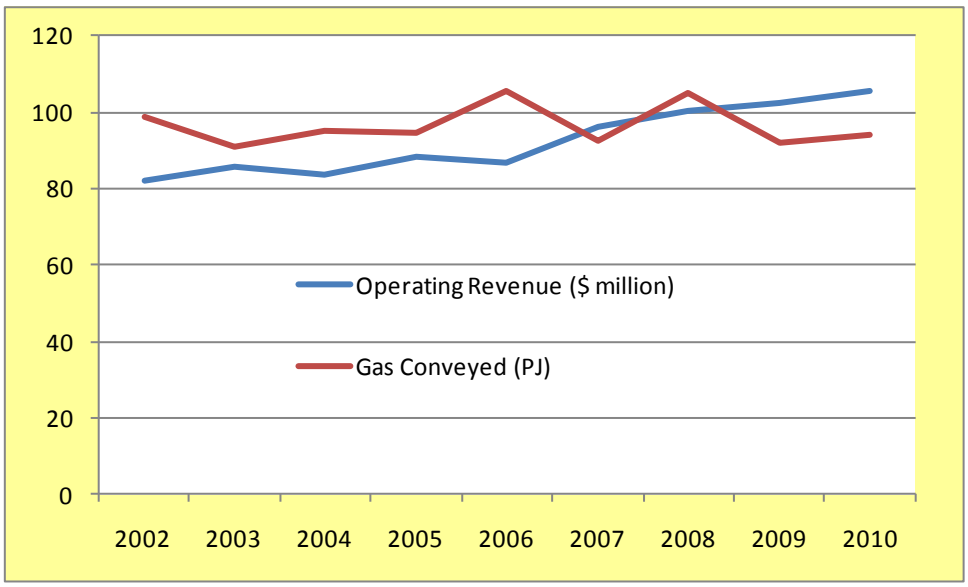
The Vector North/ Central System displays the most demand fluctuation but this is largely due to the influence of Contact's Otahuhu B station, and MRP's Southdown Plant. As already noted both of these already operate under nonstandard terms that guarantee 80-100% of the annual revenue from these sources regardless of whether they use any gas or not. Overall the demand in year ending 30 June 2010 is not materially different from the year ending 30 June 2002.

The Vector Frankley Rd system more recent increase is due to Kupe coming on line and is partly affected by gas field production from Kapuni and some smaller fields, rather than any material changes in demand.

Vector South has shown a very flat demand profile reflecting the flat residential/ commercial sector, and smaller scale, more numerous manufacturing base with no single user having a dominant effect on demand on this system.

The only system that has shown any persistent pattern to changing use is the Vector BOP system. This is a reflection of some larger user preferences for shifting to geothermal or biomass energy sources and consequently requiring less capacity reservation. These changes are often well signalled and take some years to implement such that adjustments can be made in subsequent regulatory periods.

Vector's Financial Information Disclosures also demonstrate a steady pattern of revenue growth since 2002 with only two minor interruptions in 2004 and 2006 to support these conclusions.



Source: Vector Financial Disclosure

Although we don't dispute that Vector is subject to demand risk outside of its control we question how significant important this is in relation to its expected

revenue in the context of its contract carriage regime or the stable and anticipated demand trends on its system. A switch in preference to TRC from WAPC might suggest a Vector internal view that the variable portion of income is more likely to reduce than increase in the next regulatory period and that this shift cannot be easily accommodated under a WAPC, particularly where nonstandard agreements lock in price structures with large volume customers.

A more important concern is whether a TRC provides less incentive to invest in new infrastructure since prices simply go up when demand goes down through the annual pricing adjustment process. A WAPC rewards volume growth and incentivises Vector to examine its products, services, and pricing structures to encourage demand growth on its transmission systems for the wider benefit of the market[4].

We therefore support a closer examination on the Form of Control for Vector's GTB before deciding that a TRC has preference over WAPC. In particular we think it would be helpful if the Commission could articulate its particular reasons why it now supports a TRC over WAPC.

6. Section 4: Information Required to Set Starting Prices

a. The Commission has advanced some preliminary thinking on calculating net revenue over the regulatory period that appears to favour its own judgement on GTB budgets. Our suggestion is that the GTBs should provide their own budget estimates and be prepared to justify these to the Commission. Our reasoning is that GTBs should have a better understanding of their core business than the Commission and the information required to determine starting prices is simply an extension of the normal annual budgeting processes within those organisations. The Commission can use the following reasonableness checks for this accounting exercise:

   i. The businesses are fundamentally mature and stable and examination of historical accounts should provide a reasonable basis for understanding the cost drivers of the business. These provide a ready reference point for discussing the forward projections. Our suggestion is that three to four years is sufficient. In Vector's case that includes their 2010/11 financial year. In MDL's case that would include their 2010 financial year.

   ii. GTBs are subject to normal commercial disciplines, particularly where also publicly listed, to improve returns. Thus it is reasonable to assume that the historical costs reflect efforts to lower expenses. Hence historical costs should reflect a reasonable effort to improve cost efficiency.

[4] Our view is that the pricing structure/ regime on the Vector System does have an impact on investment choices on the demand side since capacity reservation discourages users with seasonal or "peaky" gas demand as does the potential for pipelines to be contractually constrained when in fact physical capacity still exists. A WAPC incentivises more creative pricing/ product solutions and earlier investment to improve capacity or coverage issues.

b. **Revenue** – As noted by earlier comments on relative stability of demand/ revenue, a sufficiently robust forward projection of demand is entirely feasible based on analysis of historical trends at various GTB injection and receipt points, particularly for a two year period. GTBs should know the main demand drivers at each offtake point and can adjust for the few key customers who have a disproportionate effect on overall system volume. It would be surprising if the GTBs are not already doing this as it is difficult to set annual budgets for OPEX and CAPEX without these estimates.

c. **Operating Expenditure** – Again, in the light of a relatively stable business, operating expenditures should be able to be determined from historical information. It would also be surprising given the maturity and stability of the businesses if GTBs can't provide their forward projections on OPEX for the same two year period as part of a normal budgeting process. Historical costs provide the Commission with a useful check against the forward projections.

d. **CAPEX** – CAPEX budgets are also part of a normal annual budget process and for well run capital intensive businesses even more so. It would be unusual if CAPEX budgets didn't at least provide a minimum of a five-year rolling forecast. It also wouldn't be unusual to find that significant CAPEX already has a preliminary justification ascribed to it and this can be used to debate the reasonableness of the CAPEX assumptions.

From the Commission's perspective using the GTBs' own data and independently scrutinising the key assumptions in a dialogue with GTBs also narrows the scope for dispute and gives some acknowledgement to the expertise of GTBs to understand their own business.

Yours sincerely

Richard Hale

For the Major Gas Users Group