

19 December 2011

Paul Mitchell
Chief Advisor
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Commerce Commission
P O Box 2351
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Dear Paul

Re: Initial Default Price-Quality Paths for Gas Pipeline Businesses – Draft Reasons Paper 21 November 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 are mainly serviced by direct connections to transmission rather than distribution networks.
4. The MGUG main submission point with respect to the draft decisions concerns our disagreement that the most appropriate Form of Control for Vector GTB should be a Total Revenue Cap (TRC). The MGUG has consistently made this point and the draft reasoning did not provide any response as to why our reasoning was not accepted. The MGUG

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therefore wish to reinforce the concern expressed in the September submission¹ and support these with additional points. We detail our reasoning below.

5. Form of Control – Vector GTB

- a. The MGUG made a submission to the Commission in September 2011 questioning Vector's and the Commission's change of position on the Form of Control for Vector from Weighted Average Price Cap (WAPC) to Total Revenue Cap (TRC). In particular the MGUG challenged Vector's reasoning as to why a WAPC was no longer appropriate and provided a list of rebuttals to Vector's arguments against WAPC. Vector responded to these in a cross submission, some of which was excluded in the public version for reasons of "commercial sensitivity" leaving the MGUG mystified as to which parts of its argument were "incorrect".
- b. Nevertheless from Vector's cross submission it appears that one key reason is Vector's preference for lower risk.

"The fact that Vector prefers the Commission to adopt a revenue cap for its GTB, trading off potential upside from demand growth for lower risk, should accordingly be seen as a strong signal that Vector has genuine concerns about revenue uncertainty, regardless of the extent to which past revenue has been stable."² (MGUG emphasis added)

- c. Two issues arise out of this statement that are of concern to the MGUG:
 - i. There is more conjecture than evidence in Vector's statement as to why a stable past revenue pattern should suddenly become unstable in the next four years. The fact remains that Vector operates a monopoly service on its transmission system and end users who require this service have made large capital commitments to use it. Vector's special arrangements with users like generators makes their revenue largely immune from their demand swings, and other significant industrial users are currently committed to their gas investment.
 - ii. Revenue uncertainty for a monopoly should not be a driving consideration for a competition regulator, particularly where it is not being balanced against the risks being faced by the market (such as restricting demand growth in order to protect transmission revenue risk). The MGUG submits that Vector's risk tolerance in an uncompetitive market should not limit what is best for consumers. As the Commission is aware there are serious concerns about Vector's decision to declare their Northern pipeline constrained and not accept any new bookings for firm capacity. The consequences of this include adverse effects on retail

¹ MGUG Submission On Starting Price 28 September 2011 – p5

² Vector Cross-submission on the Setting of Starting Pricings for Gas Pipeline Businesses under the Initial Default Price-Quality Path Discussion Paper-Public Version – point 11

competition, and potential constraints on economic growth in the Auckland region. This is a key reason why in the MGUG's earlier submission we concluded³:

"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"

- d. This conclusion is further strengthened by recent Vector statements. Vector completed a public consultation on its methodology for capacity calculations in November⁴. As part of these consultations it also published a Question and Answer Document⁵. One of the questions (Q7.3 (p14)) asked whether Vector would allow more commercial capacity to be booked in excess of physical capacity. Included in the lengthy response from Vector was the following concluding statement:

"Finally, it should be noted that Vector does not have any commercial incentives to overbook capacity as the Vector Transmission service is regulated by the Commerce Commission. Revenue will be subject to a cap." (MGUG emphasis added)

- e. This statement is illustrative as to why a TRC will fail to meet the needs of the market, at least in the short term. It is this lack of incentive to innovate around Vector's existing investment under a TRC that exacerbates the current market issues around restrictions on retail competition on constrained systems, and continues to constrain consumers and the wider economy on energy choices.
- f. Conversely under a WAPC there is incentive to increase volume on the system by, for example, booking more firm capacity. It is then up to Vector to manage the risk for curtailment by introducing other innovations (e.g. bulletin boards, greater transparency around system flows, more convenient capacity trading, minor hardware upgrades etc). All of these innovations would benefit the current market whereas users at the moment are simply being told that they can't be given any more capacity than what they already hold
- g. It is also important to put the regulatory period in context. The initial DPP only extends to 2016 with an opportunity to reset parameters for the period after that. The period 2012 - 2016 therefore covers the immediate short term. Vector has not announced or signalled any new investment plans despite it being more

³ MGUG Submission On Starting Price 28 September 2011 – p5

⁴ <http://www.vector.co.nz/sites/vector.co.nz/files/Pipeline%20Capacity%20Consultation.pdf>

⁵ <http://www.vector.co.nz/sites/vector.co.nz/files/301111%20-%20Questions%20and%20Answers%20-%20Capacity%20Consultation%20Forums.pdf>

than two years since its initial declaration that no new capacity could be booked on the Northern Pipeline⁶. Given lead times it is doubtful that there will be any meaningful investment made in the next four years. The argument that a TRC incentivises investment is therefore more academic than real. At the same time Vector has indicated little incentive to change the workings of their current pipeline regime under a TRC. This stance will weigh heavily on the work being undertaken by the GIC to attempt to address the issues of the current system.

- h. MGUG is a participant in the GIC's Gas Transmission Investment Project whose objectives include; "*ensure that existing and future gas transmission assets are used efficiently*". MGUG recognises that in order for investment in new capacity to be efficient, use of the existing capacity should be fully maximised. If Vector feels no incentive under a TRC to innovate to attract more business, then the only other alternative is a WAPC.
- i. The MGUG's conclusion is that the Commission's draft decision to place Vector GTB under a TRC is misplaced in its reasoning. Firstly there is no evidence that Vector faces any uncertainty over its future revenue in the next regulatory period, and secondly there is no evidence for the Commission's position that a TRC "*..will provide stronger incentives for GTBs to innovate and invest*". Rather Vector's own comments would suggest the opposite; a TRC will simply preserve an unsatisfactory status quo for the next four years.

6. **Starting Prices under the Initial Default Price-Quality Paths.** The MGUG continues to support the Commission's view that starting prices should be set under s 53 P (3) (b) – i.e. based on current and projected profitability. However the MGUG also appreciates that the High Court ruling impedes progress on this until either the Commission's appeal is successful, or the Commission develops additional input methodologies. The MGUG looks forward to the release for consultation of a separate issues paper for the development of these input methodologies.

Yours sincerely



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For the Major Gas Users Group

⁶ September 2009 - Vector – North Pipeline Capacity Constraint

⁷ Gas-DPP-Draft Reasons-and-Determinations-20-Nov-2011-1 – point 5.5 (p22)