hale & twomey

ARETÊ CONSULTING LTD

27 May 2011

Paul Mitchell
Chief Advisor
Regulation Branch
Commerce Commission
P O Box 2351
Wellington

Dear Paul

Re: Initial Default Price-Quality Path for Gas Pipeline Businesses - Commerce Commission Discussion Paper dated 1 April 2011

1. This following submission is being made on the Commerce Commission Discussion Paper dated 1 April 2011 by Hale and Twomey/Aretê Consulting Ltd on behalf of the Major Gas Users Group (MGUG). While the views in this submission 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. The group has the following members:

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 recently established and has as one of its aims to promote effective/efficient market arrangements for delivery of natural gas. As such we welcome the opportunity to comment on the default price path proposal 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. We make the following comments on the paper.

3. Section 3: Structure of the default price-quality path.

a. Nature and Scope of Determination (Para 3.5) – currently Major Gas Users receive gas from gas transmission businesses (GTBs) only. We agree that transmission and distribution should be considered as different types of services requiring separate determinations.

b. Integrated Versus Separate Price and Quality Standards – we support the Commission's current position (3.20-3.23).

4. Section 4: Form of Control

a. In principle we support the factors identified by the Commission to determine whether a GTB is better suited to a total revenue cap or weighted average price cap (4.41).

b. We disagree with the Commission prescribing one or other form of control to specific companies (4.39, 4.42). In particular we note that the GIC is currently progressing a work-stream on Transmission Pipeline Capacity that may affect the nature of the Vector pipeline regime within the proposed first regulatory period. We do not want the Commission to prescribe a particular form of control to either Vector or MDL that does not allow for the form of control to change within that period. We submit rather that the form of control should reflect the nature of the pipeline regime in place and hence recognise that it could change.

5. Section 5: Claw-back

a. The major Gas Users represented in this submission have not yet been canvassed as to how their prices have been set and the impact that this has had on their business (5.27). We propose, subject to User permission, to submit further data on this matter in the cross submission period.

b. Compliance with the Price Path for Gas Pipeline Business – GTBs (5.38-5.44). We note the Commission's reliance on its formula under 5.39 in determining compliance with the price path, yet wonder why it finds it necessary to use price and quantity points from different periods to make this assessment. If the Commission sees no difficulty in being supplied cost information for the relevant period then matching quantity information should be even less problematic given the nature of transmission where everything is being measured in real time. In our view the suggested approach is unnecessarily distorting and only really works where demand changes slowly. If data collection for quantity is as difficult as suppliers seem to signal then perhaps a better approach is to apply the whole formula for a period set at t-1, or t-2 to give integrity to the outcome.

6. Section 5: Catering for Future investment Needs

a. The Commission has invited comment on the treatment of future investment (Para 5.57). Our involvement in the GIC's work-stream on investment in Vector's North Transmission Capacity indicates that investment in transmission is not occurring in a timely and efficient manner. At this stage the extent of the constraint, the investment required and timeframes remain very uncertain. Given the uncertainty for what could be a large investment we believe that the additional mechanisms provided by the Commission (5.53) are sensible.

7. Section 6: Rate(s) of Change

a. We note that the 53P(6) Act specifies that the X-factor for regulated suppliers be based on "long run average productivity improvement rate achieved by..suppliers in New Zealand..using whatever measures of productivity the Commission

considers appropriate". The approach taken by the Commission from this starting point appears to be overly complex for GTBs. Given that there are only two GTBs in New Zealand we submit that the long run average productivity improvement rate achieved by two suppliers should be a more relevant and direct measure than to consider the broader gas sector, particularly as the suppliers are being regulated not the whole sector.

b. We also note that S52A of the Act (parts c and d) contemplate efficiency gains be shared with consumers, and suppliers are limited in their ability to extract excessive profits. Given that the Commission is regulating revenue or weighted average price caps, not profitability, there is reliance for X to act as some form of control on suppliers to meet the aims of S52A.

c. The Commission appears to be accepting that despite the higher productivity identified for GTBs (as indicated by Economic Insights' comparative analysis of Total Productivity Factors (TPF) over the period 2006-2010 of -0.8% against an economy wide factor of -1.5%) an X-factor of zero is appropriate; there is no quantitative analysis to understand the impact of this difference. Given that and also the fact that the Commission is proposing to set X to zero for at least 4 years, this seems to ignore the realities of what is being achieved by GTBs as reflected in their financial disclosures. Vector's GTB for example demonstrates (in nominal terms) expenditures have been consistently declining whilst revenue and profitability has been increasing. While we have no clear view on what constitutes excessive profits, it is clear that consumers have not seen any benefits of efficiency gains over that period.

d. Based on this we strongly recommend that:

    i. The Commission undertake further analysis to consider the impact of the comparative Total Productivity Factors (TPF) over the period for GPBs and the possible impact on prices for transmission services before accepting that zero is an appropriate factor for X[1].

    ii. The Commission also consider X with direct reference to the two suppliers as allowed for under the Act, and;

    iii. Given the low correlation of CPI with productivity measures for those suppliers determine an appropriate level for X for the initial DPP.

8. Section 7: Quality Standards

a. In broad terms we support the Commission's current pragmatic approach to quality standards in terms of the measures it discusses.

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[1] We note that not all costs will be subject to inflation e.g. depreciation, interest.

b. We support measures for GTB that determine whether timely investment in transmission capacity is being made but question whether the Commission's suggested quality measures for GTBs (7.41) will accurately reflect the level of under-investment/ pent up demand in pipeline capacity.

c. We suggest that for the Vector system a further indicator would be whether a pipeline has been declared as constrained for capacity reservations, and for how long this constraint is in place.

d. Shippers on the Vector systems also have the choice of being on an interruptible supply where reserved capacity is not available. These customers are subject to curtailment and the extent of curtailment should also be reported as a measure of constrained capacity.

e. We propose these additional measures as we remain concerned from participation in GIC's work-stream on Vector Transmission Capacity that there is a lack of investment in infrastructure to overcome pipeline constraints. The current constraints have been demonstrated through GIC work to:

   i. Have anticompetitive effects in the retail gas market, and;

   ii. Lead to suboptimal investment in energy e.g. we note that there is industrial demand in Northland which is unable to be supplied with more gas because of Vector's pipeline constraints.

   iii. Lead to rising concerns that economic growth from Auckland northwards will be constrained through lack of gas transmission capacity.

   We note that S52A seeks an outcome where innovation and investment is incentivised to occur. Given the real issue of capacity constraints in gas transmission and the consequences described above, we feel there is a need to put an emphasis in the initial regulatory period on testing whether regulation has been effective in promoting the outcomes of S52A of the Act.

9. Section 8: Setting the Regulatory and Assessment Periods

a. We support the Commission's current position.

Yours sincerely

Richard Hale
Hale & Twomey Limited