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Manager, Input Methodologies Review  
Regulation Branch  
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24 March 2016

Dear Keston

**RE: Submission on Emerging Views on Form of Control Paper: 29 February 2016**

1. This submission is on behalf of the Major Gas Users Group (MGUG)
2. MGUG was established in 2010 as a consumer voice for the interests of a number of industrials who are major consumers of natural gas.
3. Membership of MGUG includes:
  - 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. These industries are a significant part of New Zealand's economy, including; the primary industry export sector, in provision of energy security, and through import substitution assisting New Zealand's balance of payments. Their manufacturing base in New Zealand relies on a secure energy supply, which for natural gas includes secure and reliable gas transport (transmission and distribution). Collectively the group has invested significant long term capital in manufacturing facilities that consume about 30 PJ per annum of natural gas, or about 15% of the gas supplied to the market in New Zealand.
5. This submission on Form of Control covers our interest in gas pipeline businesses (GPBs).
6. The focus of the submission is to address the Commission's view that a revenue cap is preferred over a weighted average price cap for GTB's and possibly also for GDBs.
7. Central to the Commission's argument for a revenue cap is the contention that gas transmission demand is difficult to forecast and difficult for suppliers to manage, and so staying with a revenue cap is more in keeping with the Commission's view that, in general risks should be allocated to the party best placed to manage them (para 45.1).

8. This view seems to have the support of GTBs, but not GDBs who wish to retain a WAPC for distribution despite the large degree of overlap between the GPBs – i.e. GPB demand is a subset of GTB demand. The only difference is that GTBs service some large users directly. However forecasting challenges and degree of influence over demand are not materially different.
9. MGUG’s view is that a WAPC is the appropriate form of control for all GPBs in context of the New Zealand Gas market and the forecast horizon (2017-2022).
10. A WAPC provides stronger incentives than a revenue cap to GPBs to grow demand and avoid loss of demand, since any benefits in growth in volume will accrue directly to the supplier and any loss in volume similarly act adversely on their total revenue, and hence profitability. Presumably this also appears to have been the Commission’s view in 2010 Reasons paper<sup>1</sup> (with our emphasis added)

suppliers should bear the risks that they are best placed to manage, *including risks* of any cost variations and *demand risk* (consistent with s 52A(1)(b)(d))

11. GPBs have a large degree of latitude under their pricing methodologies to set prices to individual customers. Pricing is not regulated and broad pricing principles set by the Commission are not mandatory. Basic economic principles suggest that pricing does influence demand and if this is accepted then it must follow that GPBs do have an ability to manage demand risk and it is appropriate that they should be exposed to that risk when individual users have no control over the demand of others.
12. MGUG experience in the last regulatory period under a revenue cap has been that suppliers have been incentivised under their view that demand might fall, to transfer as much demand (volume) risk as possible on to consumers through pricing methodology mechanisms. Arguably this would not have occurred to the same extent under a WAPC. Vector GTB’s defensive approach to demand risk became a self-fulfilling prophecy as they moved quickly to a higher fixed cost tariff structures to reduce impacts of what it predicted would be a falling volume demand on its systems. Vector also maintained its large number of non-standard agreements that acted as further disincentives for Contact Energy and MRP to maintain their thermal power stations on Vector’s North Systems.<sup>2</sup> The result were annual price increases of 23% and 25% respectively to standard customers, including our members.
13. Given that GTBs have total control over pricing, and hence demand drivers, we also address the Commission’s contention that volume is not predictable by GTBs. This distils down to the argument that forecast predictability is asymmetric – i.e. consumers can forecast their own demand more accurately than the supplier can. MGUG disputes that GTBs cannot be as well, if not better informed than consumers on aggregate demand on its systems.

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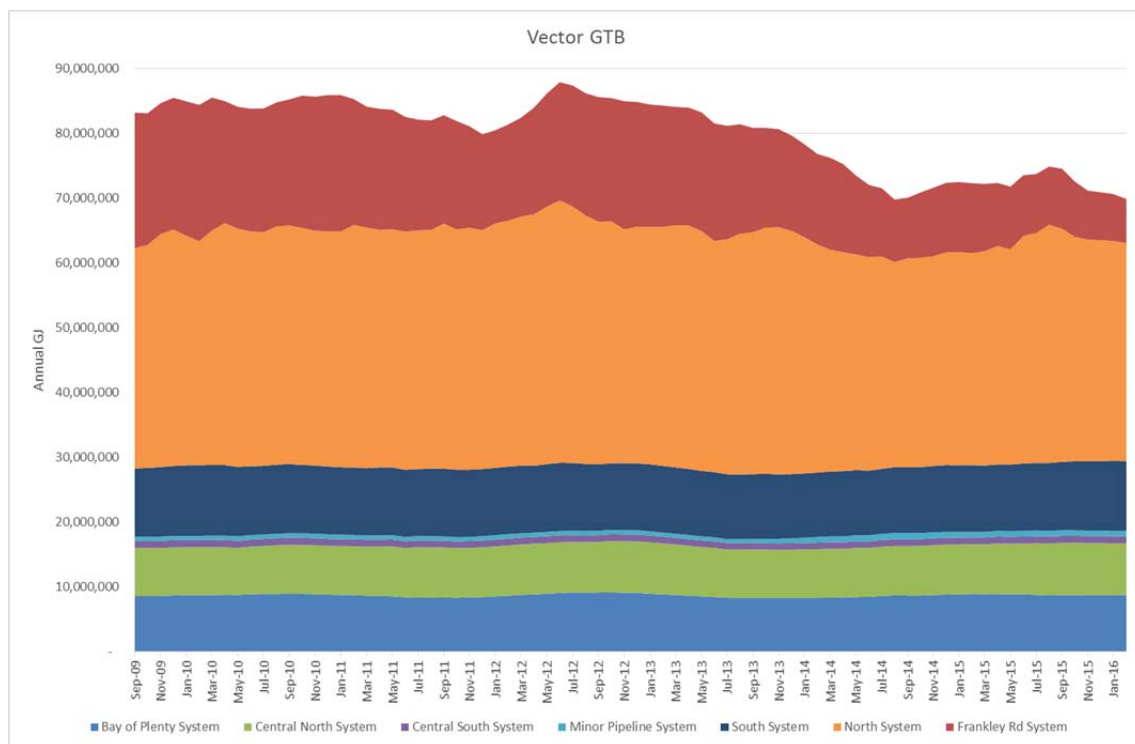
<sup>1</sup> Input methodologies (electricity distribution and gas pipeline services) reasons paper (December 2010), para 8.2.11

<sup>2</sup> Contact was paying approximately \$6 million pa in fixed charges and MRP approximately \$4 million in fixed charges simply for an option to transport gas when a more variable fee structure would have offered a lower risk for them.

*GTB Forecast Predictability*

14. Over a large section of the gas market demand is remarkably stable. Below are graphs depicting physical gas flows across different parts of the gas pipeline system using data from OATIS<sup>3</sup>. The figures are volume flows, not revenue flows generated from tariff structures. However tariff structures as already mentioned are completely within a supplier’s control so what matters here is whether volume can be predicted with reasonable confidence<sup>4</sup>.

15. **Fig 1** - Vector GTB annual demand over 6 ½ year period



16. Vector’s flows relate to demand (delivery) points and doesn’t include receipt flows. However under a common ownership structure combining both Vector and Maui pipelines, supply always matches demand and net flows across systems will not be an issue going into the next regulatory period.

17. Points to note from the above graphic is that demand is stable on most of Vector’s subsystems. Analysing this further by key demand drivers on each system there are exposures to some key users, but within the forecast period the demand is relatively predictable. This is either because of portfolio effects in the mass market (many

<sup>3</sup> The graphs show running 12 month totals to remove seasonal variations.

<sup>4</sup> Each GTB has its own pricing methodology and complete freedom to structure tariffs and pricing according to what it thinks is commercially sensible for them. The Commission sets broad pricing principles but makes compliance to these voluntary. If revenue flows are more volatile than physical flows then this is not a demand issue, but a pricing one.

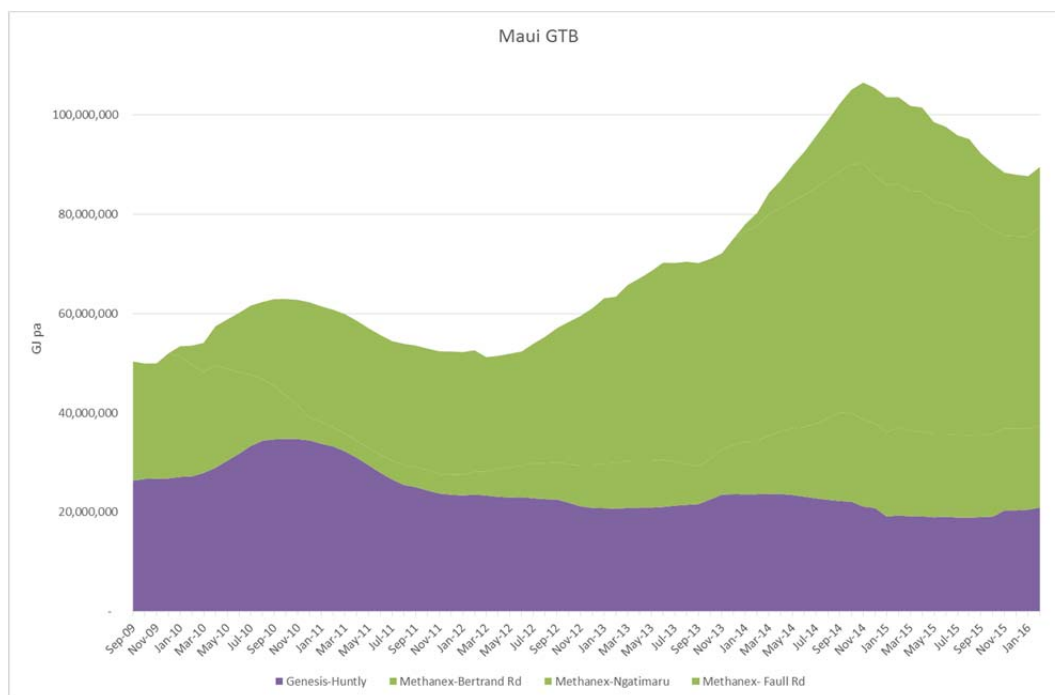
independent consumers including commercial and small industrial), and because larger remaining industrials do not face an imminent threat of closure. This is for all cases, including Vector North, where the closure of Southdown and Otahuhu B has removed a large uncertainty on further significant losses<sup>5</sup>.

18. Frankley Rd delivery points decrease is a consequence of Contact TCC’s reduction in demand from 14.7 PJ pa (Sep-09) to 0.5 PJ pa (Feb-16). Major users on that system, including Ballance Agri-nutrients and Contact are more likely to see demand increases than decrease going forward<sup>6</sup>.

19. In the few instances where there are some large users, such as Contact Te Rapa (4.2 PJ of demand) or Ballance (7 PJ pa) these volumes are stable, and there is no reason why a GPB might not also request and rely on those companies’ own forecast to remove information asymmetry if it felt that this was important.

20. **Fig 2 – MDL GTB annual demand over 6 ½ year period**

Netting out the flows entering Frankley Rd, Pokuru, Rotowaro, and Vector minor system demand points (included in Vector GTB flows) the only remaining demand points on the Maui pipeline are Methanex and Genesis (Huntly).



<sup>5</sup> Auckland (12 PJ pa) is growing at about 1% pa, Refining NZ (2 PJ) is looking to increase its demand both in near term, and after Henderson Compressor upgrades in 2017, NZ Steel (2 PJ) and Fonterra (1.1 PJ) are stable, Tuakau has increased as result of new dairy plant, and Oji is investing in gas demand to offset some loss from Southdown cogen closure to generate its own steam.

<sup>6</sup> Ballance is looking to increase plant capacity and is currently seeking financing partners. Contact is using its peakers and is likely to see greater use of TCC after Otahuhu B closure (if not, less than 0.5 PJ pa is at risk) and Todd has indicated that it has plans for a new peaking plant near New Plymouth.

21. In terms of total demand across all transmission Methanex and Genesis do have a large share of the total deliveries on Gas Transmission. Arguably therefore the greatest demand forecast risk follows from these two customers in the next regulatory period. However both customers, through public disclosures have indicated a high degree of stability in their operations. The most recent statement by a senior Methanex executive is that it considers New Zealand as a strategic manufacturing point and provided sufficient gas supply is available Methanex is looking to maintain all of its three facilities in full operating mode<sup>7</sup>. Similarly Huntly demand is dominated by e3p CCGT on the back of Kupe gas supply. Genesis' position on Huntly continuing as a thermal generation site is also positive<sup>8</sup>.
22. Again dealing with only two customers, there is no reason why a prudent GTB would not request and rely on consumer forecasts to remove potential information asymmetry.
23. Notwithstanding that circumstances could change for these two customers, particularly Methanex, the revenue impacts are also muted by the lower transmission fee on the Maui system<sup>9</sup>.

#### *GTB Summary*

24. The forecast risk and inability to influence demand on GTB is overstated in the context of the forecast horizon (2017-2022), gas market participants, and the complete control GTBs have under their pricing methodology to set tariffs that encourage volume to stay or grow. Accordingly the reasoning for a revenue cap over a WAPC is significantly weakened.
25. WAPC provides stronger incentive for GTBs to maintain and grow business than a revenue cap. This benefits consumers also as greater asset utilisations keeps prices lower.

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<sup>7</sup> Methanex eyes further NZ Capacity – 6 Oct 2014 <http://www.energynews.co.nz/news-story/18900/methanex-eyes-further-nz-capacity>

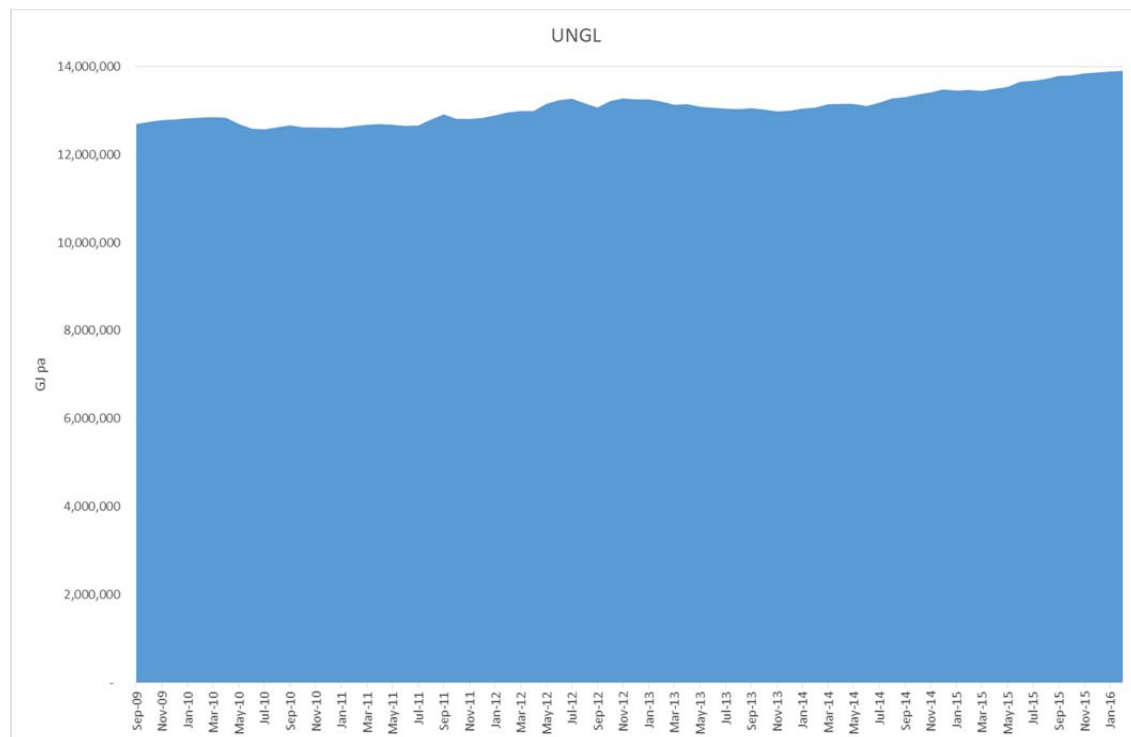
<sup>8</sup> <http://www.energynews.co.nz/energy-resource/combined-cycle-gas-turbine/1128/huntly-unit-5-e3p> The company says electricity generation will continue at the Huntly site for many years to come from the two existing gas-fuelled units, including Huntly Unit 5. Genesis also says the site remains extremely well positioned to develop additional thermal peaking capacity, should that be required in the future.

<sup>9</sup> We estimate that Methanex paid approximately \$7 million in transmission cost in YE 29 Feb 2016 out of a total of approximately \$130 million in transmission revenues. This equates to about 5% of revenue for 40% of the total deliveries – ie 5% of revenue is at risk if all of Methanex volume disappeared in the next regulatory period (an unlikely scenario)

*Gas Distribution Businesses (GDB)*

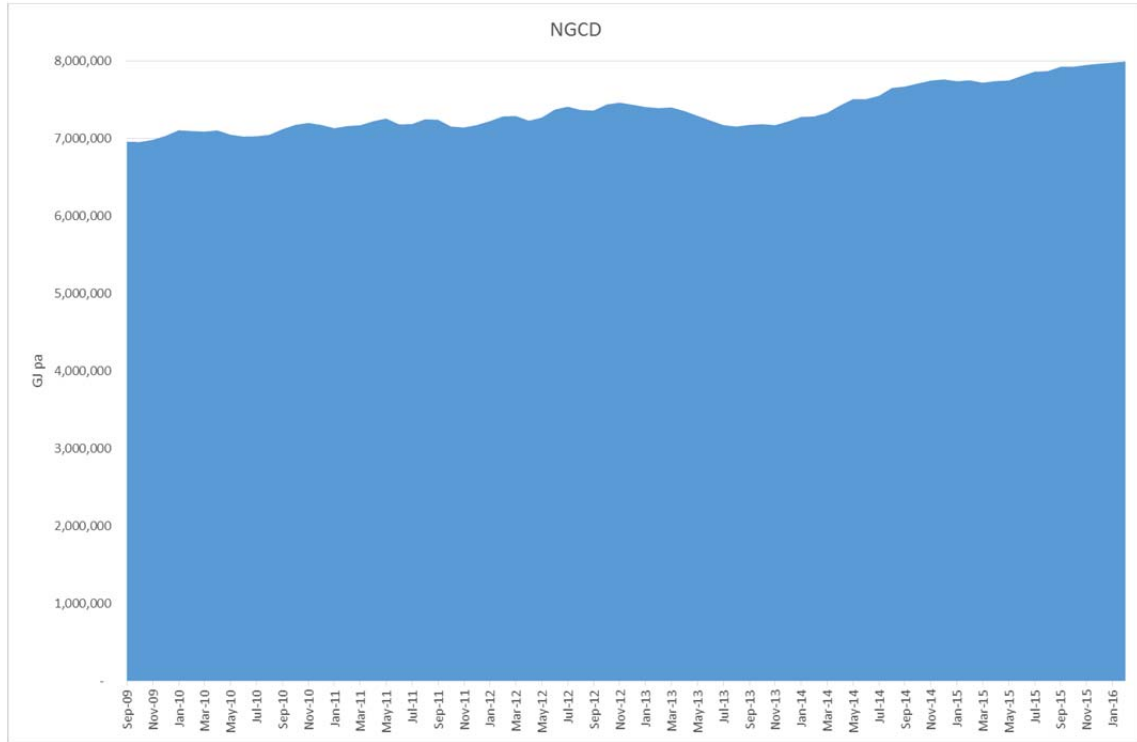
- 26. MGUG also supports a WAPC as the form of control for GDBs.
- 27. The various networks demand profiles are shown below (Fig3-Fig 5) to explain why WAPC might also be favoured by GDBs.<sup>10</sup> Generally distribution demand is growing which makes WAPC a logical choice for GDBs to beat the regulatory settings.
- 28. However in supporting a WAPC, GDBs are also effectively telling the Commission that GDBs can influence demand and have reasonable assurance on ability to forecast accurately, a position that MGUG agrees with and is also arguing applies to GTBs.

29. **Fig 3 – UNLG (Vector Auckland GDB)**

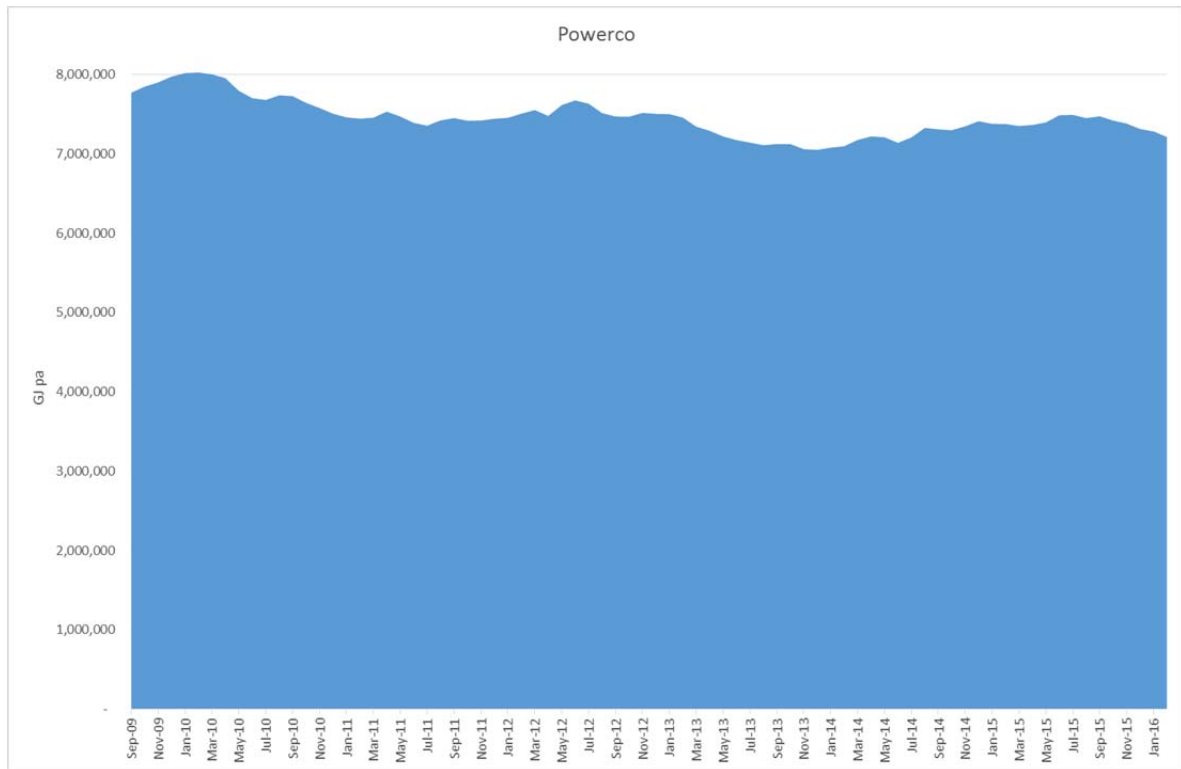


<sup>10</sup> The figures are based on networks as currently assigned by gas gate. Where UNLG has transferred some of the previous NGCD gates these have been adjusted in the totals prior to the transfers in July 2015

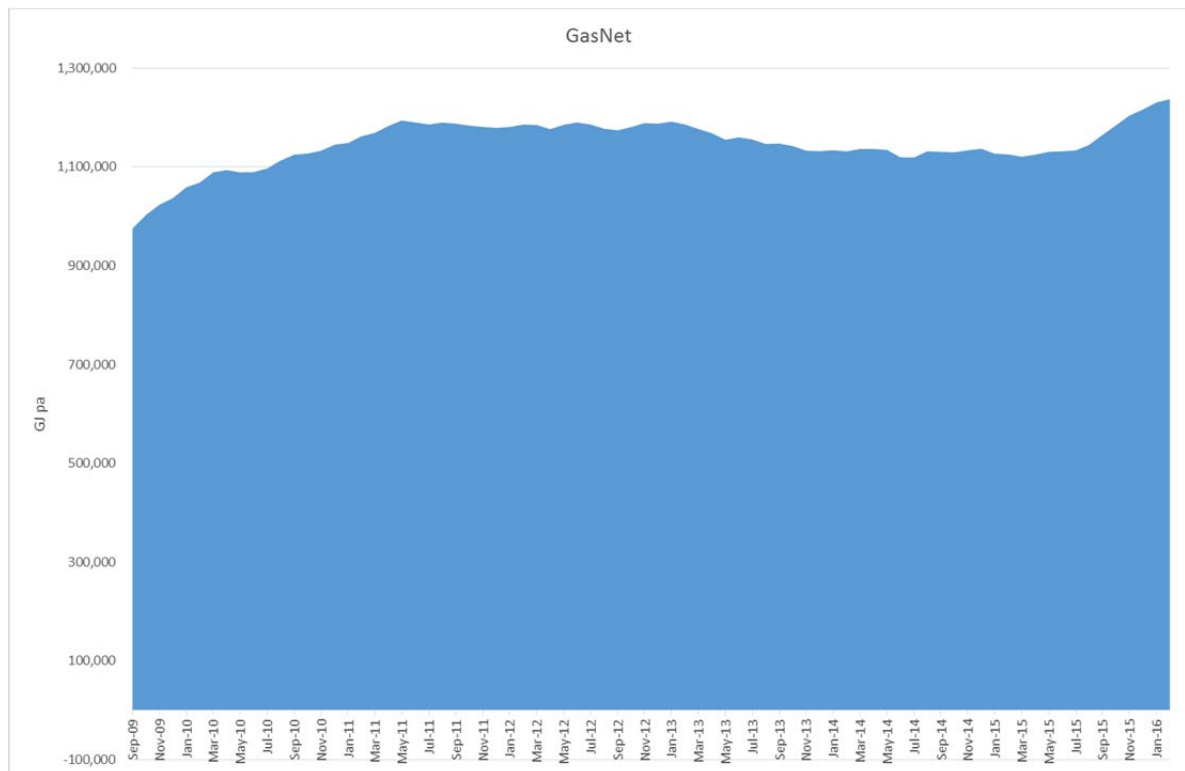
30. Fig 4 – NGCD (Colonial State First GDB)



31. Fig 5 – Powerco



32. Fig 5 - GasNet



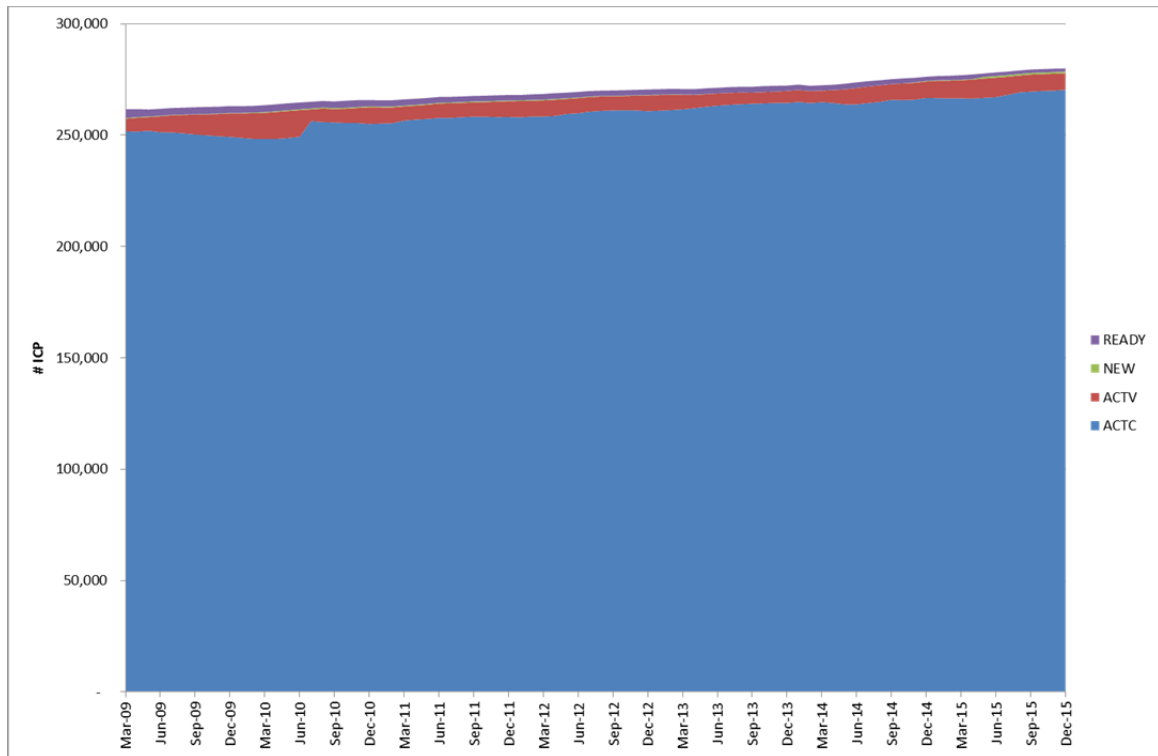
33. There are two drivers for demand growth in GDBs:

- Growth in connections creating consumer options for energy mix.
- Relative competitiveness of delivered gas to other fuel alternatives, including electricity.

34. Connection growth, and the stability in this pattern is shown in Figure 6



35. Fig 6 – 7 year connection growth<sup>11</sup>



36. Fig 6 combined with Figs 3-5 provide a reliable basis for forecasting GDB demand over the next regulatory period.

### GDB Summary

37. An important message from suppliers is that GDBs believe that they should take on demand risk, and that they have the ability to manage this better than anyone else, including consumers.

38. Demand patterns in GDB market and suppliers' freedom and ability to determine tariff structures to influence demand explain why suppliers have this view.

<sup>11</sup> Source GIC

*Overall Conclusions*

39. MGUG supports the Commission's December 2010 reasoning that "suppliers should bear the risks that they are best placed to manage, including risks of any cost variations and demand risk"
40. MGUG disagrees with the Commission's reasoning for a Revenue Cap for GTBs. In particular MGUG believes the Commission's statement that gas transmission demand is difficult to forecast and difficult for suppliers to manage is not supported by the evidence that GTBs exercise a great degree of influence on demand through its tariff structures set under unregulated pricing methodologies, and the gas market itself which has demonstrated remarkable stability over time to give confidence in accuracy of demand forecast models for the next regulatory period.
41. In the isolated cases of a few large users, information asymmetry on demand can be easily and cost effectively addressed by GTBs through information sharing and confidentiality protocols. Tariff structures can also act to reduce supplier volume risk to less stable customers.
42. If gas transmission is not difficult to forecast and suppliers have a degree of control over demand risk then the argument for a revenue cap as a form of control appears rather weak. A WAPC does provide stronger incentives for demand growth and incentives to avoid demand loss. This incentive on GPBs also benefits consumers since it is also in consumers' interest to see GPB assets fully utilised in order to keep prices down.
43. This submission is not confidential. Some members may make separate submissions.

Yours sincerely



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