MAJOR GAS USERS GROUP

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4 August 2016

Dear Keston

RE: Input methodologies – draft decisions

1. This submission is on behalf of the Major Gas Users Group (MGUG) in response to the Commission's consolidated draft decision papers of 16 June and Report on the IM review of 22 June 2016.
2. MGUG members have been consulted in the preparation of this submission. Nothing in this submission is confidential. Some members may choose to make separate submissions.
3. MGUG was established in 2010 as a consumer voice for the interests of a number of industrials who are major consumers of natural gas. We have been involved in the current IM review process since the IM Review Forum on 29-30 July 2015.
4. 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
5. Contrary to the many references made by the Commission in its draft reasoning gas is not a discretionary fuel for our members who have made long term capital investments in plant and processes reliant on gas.
6. Our comments on the draft IM decisions cover our interest in gas pipeline businesses (GPBs).
7. Our submission is limited to comments on the engagement process, Form of Control for GTBs, and WACC. The key messages from this submission are:
    a. The form of control for GTB should be a Weighted Average Price Cap (WAPC).
    b. The option of a WAPC form of control for GTB should not be removed.

c. WACC methodology seems at odds with observed outcomes and reasonableness checks.

d. Debt issuance cost should be no higher than 10 basis points (bps) per annum.

e. Asset Beta should be no higher than 0.30 for GPBs.

Engagement Process

8. The Commission's efforts to engage with stakeholders through the IM review have been appreciated by MGUG as has the readiness and availability of Commission staff to answer questions on various sub topics. Nevertheless we offer a few comments and observations on the process to provide context to our submission.

9. We would note that on a topic such as monopoly regulation engagement is inherently asymmetric because many diverse uncoordinated consumers are asked to compete with submissions against the concentrated interest of suppliers. We see this as a weakness in the engagement process where the Commission relies on often quite technical evidence from economic experts for it to consider. It is not surprising that suppliers are able to invest more in this process to convince the Commission of its case.

10. We appreciate that the Commission is aware of this and works hard to try and address this imbalance by encouraging consumer input. However for consumers without dedicated regulatory affairs functions it is extremely difficult to stay across all of the often technically challenging topics, their evolution, precedents, and extensive documentation accompanying these type of reviews.

11. To help improve consumer engagement it may be beneficial if the Commission were to provide on-line resources to make clearer and demystify various topics related to the regulatory inputs, outputs, controls and linkages between them. In some cases the Commission has set up focussed dialogues with consumer groups, which has been helpful (we think for the Commission as well). We think this is beneficial. An ongoing dialogue with identified consumer groups on more focused topics may also assist in helping to build consumer capacity for future engagement.

12. The opportunity to include GPBs into the IM process was identified early by the Commission despite the reset for gas DPP not being until May 2017. MGUG welcomed this initiative on the basis that members' experience with the current settings were less than satisfactory and allowing these conditions to continue until 2022 before realising any benefits wasn't acceptable to members.

13. However we believe there is a downside with the timing of the IM review (in the context of the later GPB regulation) in that the process has perhaps prevented the opportunity for a clearer assessment of the regulatory outcomes for GPBs in the way that the Commission has been able to provide for EDBs (by analysis of EDB profitability and investment). Hence, despite the Commission's best efforts and good reasons to involve gas early we have found it difficult to engage effectively due to lack of clarity on problem definition for GPBs. Even nearing the end of this IM Review process it is still not apparent to MGUG whether the

current IMs are helping to deliver benefits to consumers and how the proposed changes might improve S52A outcomes.

14. Nevertheless we've engaged in spite of these limitations because member experience with GPBs behaviour has suggested there may be problems with the regulatory settings. These problems include;
    a. significant price shocks to pipeline charges (Vector GPBs);
    b. continued investment deferment on bolstering Maui pipeline security;
    c. lack of innovation in products and services despite extensive engagement through the GIC;
    d. and recent sale of pipelines above their RAB value suggesting that profitability might be higher than intended under S52A outcomes.
15. Aside from some of these more general observations some aspects of our engagement experience felt disjointed and confusing as the Commission divided the greater project into a number of work-streams. This often meant dealing with different Commission staff members on separate topics who weren't always fully briefed on the work that other parts of the organisation were engaged with or sensitive to some of the linkages.
16. For example the Commission's emerging view on Form of Control was for a pure revenue cap for GTB and weighted average price cap for GDBs. Constant Price Revenue Growth (CPRG) is a subset of the form of control topic dealing with forecasts under a weighted average price cap. MGUG was invited to attend the 25 May 2016 workshop on CPRG which covered the reliability of demand forecasting for GDBs only. MGUG's expectation was that the Commission had only developed emergent, not firm, views on form of control. We were surprised therefore about the limited scope of the CPRG work-stream, particularly that it didn't include forecast issues for GTBs should a weighted average price cap be adopted as the final decision on the form of control. This is more so given that the reason for the different forms of control rested quite strongly on assumptions that forecast accuracy was a problem for GTB but less so for GDBs. In our view this would have been the right forum to demonstrate and debate the Commission's evidence on this but this was largely prevented because of too narrow a scope definition for CPRG.
17. We note the Commission intends holding a workshop on cost of capital topics on 7 September 2016 following the deadline submissions and cross submissions on the draft decisions. This wasn't contemplated in the timetable and we would be disappointed if this was intended to provide an opportunity for suppliers to re-litigate outcomes with which they are dissatisfied, given the process already provided to hear supplier concerns.
18. In closing the overall context of our submission, MGUG remains aligned with the Commission as well as suppliers on achieving the purpose of Part 4. We see no consumer advantage to deny suppliers a normal rate of return commensurate with their risks, we want suppliers to innovate and achieve efficiencies that can be shared with consumers through lower prices, and we want economically efficient investment to occur. The lack of clarity on

whether these things are actually being achieved coupled with members' dissatisfaction with what they are currently experiencing and interpreting is what has stimulated our engagement with this process.

Topic paper 1 – Form of Control

19. For GPBs the Commission has maintained its emergent view position that the GTB should be subject to a Pure Revenue Cap and GDBs to a weighted average price cap (WAPC). MGUG has submitted extensively on this topic including the initial IMs that the Vector GTB should have been subject to a WAPC form of control. We continued to advance and extend our reasoning in our submission on the Commission's emerging views[1].

20. In examining the Commission's reasoning in the draft IMs we do not find any reliance on evidence disputing our arguments. Instead a rather broad and unsubstantiated assertion is made that "*gas transmission is difficult to forecast*"[2] and that "*this criterion was given the greatest weight in our assessment*"[3]. It further notes that gas demand is impacted by factors that are out of the supplier's control as reasoning for its decision.

21. We do not consider these to be strong or even consistent arguments since exactly the same factors exist for GDBs, yet the Commission takes an opposite and contradictory view for GDBs.

22. Firstly, certain demand factors are also outside of the control of other consumers. Whether an individual consumer chooses to connect or disconnect to gas is not influenced by other users but by the relative long run competitiveness of the energy supply. This competitiveness is influenced by factors including costs and cost allocation models for gas transport, i.e. tariffs set by suppliers. For example our members had no influence on Contact and MRP's decision to shut down their gas fired power stations in Auckland. In turn it is arguable that the decision to shutdown was partly influenced by their transmission contracts costing $11million pa for a transmission service that no longer suited their demand profile. There was no risk to the Vector GTB to lose this volume under their pricing methodology and revenue cap and hence less of an incentive to alter their pricing structure (had they been under a weighted average price cap) to avoid this permanent loss of demand. The end result was an estimated additional $3.0 million annual charge to our members[4] for something over which they had less control than the supplier. Based on the risk allocation principle, on which the Commission has placed some weight[5] for its decisions, the supplier is, in these types of cases, in a better position than consumers to manage demand risk. This makes it difficult to accept that the consumer of the regulated service should be facing all the demand risk as an outcome of a revenue cap.

[1] MGUG - Submission on Emerging Views on Form of Control Paper: 29 February 2016
[2] Topic 1 – p36 para 145.3
[3] Topic 1 – p40 para 165
[4] Based on sites on posted price schedules. Excludes Fonterra Northern Dairy Plants, Refining NZ, and NZ Sugar for which there is no public information.
[5] Framework for the IM review – p40 para 130

23. In any case we see no distinction between GDB and GTB customers with regard to demand risk. Arguing that GDBs have the ability to influence the uptake of gas because they can promote gas to people not connected to an existing network but somehow GTBs can't do the same, ignores the similarities and interdependencies of GTB and GDBs

24. For the GTB the Commission makes a strong statement without presenting any evidence, that forecasting is difficult. In contrast the Commission seems satisfied that forecasting is not an issue for GDBs[6] despite its own commissioned evidence showing the opposite[7].

25. The Commission supports this reasoning with the statement that "*there have not been any significant problems raised with the CPRG forecasting for gas distributions*". We raise two points here. Firstly "not been raised" does not imply that forecasting is somehow better than for GTBs. It depends on who raised it as an issue for the GTB. Secondly the forecasting difficulties for GDBs are not trivial as was outlined in the presentation that Concept Consulting made at the Commission's CPRG workshop of 25 May 2016[8].

26. Slide 8 in that presentation discusses analysis limitations on how forecasts have performed including "*Limited years of disclosure (ID) data*" – or to be more precise less than two years of the initial period. Unsurprisingly forecast accuracy for these periods was reasonably good but not any better, in our experience, than can be achieved for the GTB over the same period. The more robust test of forecast accuracy is how it performs over five years, not less than two.

27. The presentation also highlighted gas demand volatility and the inability to describe an adequate demand model for forecasting purposes. Nevertheless it still uses a model with no demonstrable correlation with demand to forecast gas demand. The model assumed a range of probable values in the demand predictors[9] to develop a range of possible outcomes. The output generated shows forecast accuracy deteriorating with time, with possibilities ranging from less to more gas than present. The lack of a strong claim to accuracy is made in the caveats that those projections should be treated with strong caution, considering the inherent uncertainty of the model assumptions.

28. The meeting notes[10] conclude "*Gas demand is more volatile than that of electricity which, coupled with limited historical data, makes CPRG forecasting difficult*." Nevertheless the Commission still felt that "*there appeared to be no fundamental problem with the existing CPRG approach*"[11]

29. We would conclude from that statement that there wouldn't be any fundamental problem with a CPRG approach for the GTB either.

[6] Topic 1 – p44 para 188
[7] CPRG Workshop 25 May 2016
[8] Gas DPP Slides for CPRG Workshop 25 May 2016
[9] Low medium high projections for GDP, Population, energy efficiency/ gas share
[10] Gas DPP Summary of views Constant price revenue growth workshop 25 May 2016 – para 13
[11] Ibid – para 33

30. We have contrasted the two approaches to the forecast accuracy perception to point out the inconsistency in the Commission's reasoning. If the Commission felt the need to make a distinction between forecast accuracy for the GTB and GDBs then we would have expected the Commission to have done a similar analysis for GTB forecast modelling to show why forecast accuracy is more problematic for the GTB then the GDBs.
31. In terms of forecast uncertainty we reiterate our argument that GDB forecast is a complete subset of the GTB forecast. If GDB forecast accuracy is not a problem then it is also not a problem for the GTB for that portion of its demand. Secondly other GTB demand going forward, particularly in terms of revenue sensitivity does not seem to have a large amount of uncertainty related to it. Our reasoning for forecast confidence has been outlined in our previous submission on that topic.
32. The Commission also argues for a pure revenue cap for the GTB on the basis that it will remove compliance barriers to offer more innovative tariffs[12]. We understand that the Commission might be referencing an MDL submission on auctioning of a capacity product on the Maui pipeline. We do not consider that this argument needs to be given much weight for two reasons.
33. Firstly change to the access regime, including tariff structures under the long anticipated code convergence, is yet to even begin. Whatever the outcome of that process the basic structure of fixed and variable components is unlikely to change. The form of control may influence the outcome but it is unlikely to be an impediment since the two extremes already exist under the current regime.
34. Secondly the auction based capacity product was a solution proposed by MDL to bring in a capacity product for the Maui system to align products with the Vector Transmission Code (VTC) as a step towards code convergence. It should be noted that there is currently no demand for a capacity product on the Maui system, nor is one anticipated even in the medium term. Furthermore, if a capacity product was introduced it is by no means clear that it should be auctioned by the pipeline owner rather than sold at a fixed price and then traded between shippers on a secondary market circumventing any issues around revenue uncertainties
35. The Commission chose incentive regulation over rate of return regulation in 2010[13] on the basis that the regulatory objective was to provide incentives to suppliers to improve their efficiencies and provide services at a quality that reflected consumer demands. We would note that based on the current experience with a revenue cap the outcomes have been the opposite. Pricing methodology on the Vector GTB moved to a higher fixed tariff structure which disincentives existing and new demand with low load factors like seasonal processing industries[14]. The period is also characterised not by a shortage of ideas by consumers on

[12] Topic 1 – p37 para 148.3
[13] Initial Default Price Quality Path for Gas Pipeline Businesses Issues Paper 12 April 2010 – Section 4
[14] There may be a rationale for this if pipelines are physical constrained such that capacity becomes a scare commodity but this is not the case for the Vector systems.

how to improve transmission products to better meet consumer needs but a failure by the GTBs to make any progress on developing and implementing these[15].

36. In conclusion we continue to support a weighted average price cap for the GTB and GDBs on the basis that this form of control provides stronger incentives to innovate, invest, and find efficiencies which benefit consumers, and hence better promotes the purpose of Part 4.

37. Because the Commission has not in our view settled the case or presented a strong evidence-based rationale for a pure revenue cap for the GTB we also strongly oppose the Commission's intent to remove the option of a weighted average price cap for GTB from future determinations.

Topic 4 – Cost of Capital Issues

38. We continue to have reservations about the ability of the WACC model to provide an unbiased assessment of regulated suppliers' actual profitability. There are two observations for which we have sought explanations that appear to support the idea that WACC methodology systematically underestimates actual profitability.

39. In our first submission on this topic[16] we pointed to a number of web site references from Colonial First State Global Asset Management (CFSGAM) who acquired the Vector Transmission system indicating their expectations that despite spending more than the value of the RAB their purchase would yield a net IRR of 9-11% pa over the life of the investment. We have difficulty reconciling this number with current 67th percentile WACC determination for the GTB of 6.35% and 7.18% in July last year.

40. We also note the Commission's analysis of EDB profitability[17]. Despite most EDBs not achieving their regulated return, investment in most cases was substantially higher than historically. We find it surprising that EDBs would increase investment considerably above historical rates when on the face of it they were unable to achieve a return on capital on their existing investment.

41. We don't consider that any of these matters in their own might point to a failure in methodology to ensure that suppliers are not earning excessive profits. However with the Commission not having provided any evidence to the contrary we feel it necessary to question whether the WACC methodology is fit for purpose.

42. In pointing to these examples we also note that the Commission has itself acknowledged that the SBL-CAPM biases WACC in favour of suppliers[18]. We suggest that our examples provide more concrete evidence for that.

43. Notwithstanding our reservations on the suitability of WACC measures to limit profitability we also have reservations about a number of model settings.

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[15] E.g. shorter term capacity products, capacity trading.
[16] MGUG Submission on IM review cost of capital 5 February 2016
[17] Report – Profitability of electricity distributors following first adjustment to revenue limits – 8 June 2016
[18] Topic 4 – P135 para 529 and 531

Cost of Debt

44. We question why the Commission would suggest a debt issuance cost allowance of 20 bps pa when its own evidence suggests that it is "*more likely in the range of 5-10 bps pa*"[19]. The terminology "likely" suggests greater than 66% probability[20]. If the 67th percentile guideline is taken from WACC error as an acceptable tolerance to avoid the risk of underinvestment it suggests that issuance cost allowance should not be more than 10 bps pa. We see no evidence supporting a further buffer to suppliers.

Asset Beta

45. The same level of inconsistency is noted in the reasoning to support an asset beta of 0.34.

46. Despite finding in its own evidence of comparator firms that the most recent five year period asset beta averaged 0.30[21] the Commission has justified 0.34 on the basis that this also agrees with supplier lobby groups' submissions[22]. It does so whilst discounting a competing consumer submission (Contact) saying asset beta might be no higher than 0.19 based on a competing selection of comparator firms that more closely compare to the actual characteristics of the New Zealand firms being regulated.

47. One of the reasons for the Commission dismissing Contact's argument is that its estimate was "*significantly below the range of comparative information included in Figure 6 above*". Given that Figure 6 primarily includes suppliers' estimates[23] for asset beta the Commission does appear to be implying that supplier estimates are somehow more reliable than its own or other consumer representative estimates.

We reinforce this point by also noting that the Commission also came up with a lower average asset beta of 0.31 in Table 4[24] using Contact's approach to only try and include "true" comparator firms. The 0.31 was consistent with its alternative analysis in Table 2[25] which also included an asset beta of 0.19 for Vector. Despite an alternative approach supporting its own analysis it is surprising that the Commission insists that 0.34 is still the correct number to use. We think that more weight should be given to the supporting evidence from the most recent periods.

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[19] Topic 4 p60 para 244
[20] There is no universal standard on how qualitative risk terminology translates to quantitative probabilistic terms but the IPCC for example has achieved some consensus on how this applies to their use of the term - see https://www.ipcc.ch/publications_and_data/ar4/wg1/en/ch1s1-6.html
[21] Topic 4- Table 2 P70 para 289
[22] Topic 4 – p73 para 304-306
[23] Also a 2012 estimate from the UK regulator for the UK market
[24] Topic 4 – p77 para 317
[25] Topic 4 – p70 para 289

Reasonableness Checks

48. Our opening points under cost of capital issues regarding suitability of WACC methodology is also part of our submission on reasonableness checks. If WACC methodology underestimates actual profitability we think that this is an important point to investigate.

49. The Commission has considered RAB multiples achieved in the recent sale of Maui and Vector GTBs and NI Vector GDB as helpful evidence.[26] It further noted that the NPV of expected cash-flows should, if the regulator's assumptions hold, equal the value of the RAB. That is the RAB multiple should be 1.0[27] Reasons outlined by the Commission as to why the multiple might be greater than 1.0 include; the regulatory allowed rate of return is too high; or the market (i.e. buyer) expects to outperform assumptions used in the regulatory determination[28].

50. The second reason for a higher multiple is essentially the same as the first since a buyer can only consistently outperform the regulatory settings if the methodology for limiting profitability is underestimating it.

51. The Commission's evidence suggests that the RAB multiple for the Vector GTB/GDB acquisition was in the range of 1.33 – 1.50 and 1.14 for the Maui GTB. After adjusting for its proposed adjustments to beta the conclusion is that Vector GTB/GDB RAB multiple is 1.17 to 1.32 and 1.0 for Maui GTB. The Commission concludes that because the multiples are still greater than 1.0 that the settings are "sufficient" to compensate investors for putting their capital at risk.

52. We disagree based on the Commission's own reasoning on what a multiple greater than 1.0 implies. Settings are not "sufficient", they are demonstrably excessive.

53. Whilst we are unable to go to the extent of commissioning our own economic expertise as evidence we have instead relied on testing the consistency of the Commission's reasoning. We have also made a number of observations on outcomes and identified conflicts with regulatory assumptions.

54. On the basis of this approach we are not convinced that the underlying methodology for WACC adequately reflects real performance.

55. Even assuming that the methodology will continue we submit that debt issuance cost should be 10 bps pa and an evidence supported asset beta cannot be higher than 0.30.

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[26] Topic 4 – P145 para 572
[27] Topic 4 – P161 para 613
[28] Topic 4 – P161 para 614

Yours sincerely

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