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Open letter: Trustpower's concerns about the ability of the current GTAC proposal to provide access to the gas transmission network on reasonable terms

1 Introduction and purpose

- 1.1.1 Trustpower Limited (**Trustpower**) has been actively involved in the design by First Gas of a new Gas Transmission Access Code (**GTAC**) to replace the current Maui Pipeline Operating Code (**MPOC**) and Vector Transmission Code (**VTC**).
- 1.1.2 We fully support the development of an open and compatible transmission access arrangements across both pipeline networks and note this has been a policy objective of Government since the ACIL report¹ was issued in 2001.
- 1.1.3 Whilst acknowledging the efforts First Gas has put into developing a unified access code across both transmission pipeline networks, we have limited confidence that the Government Policy Statement (**GPS**) objectives and outcomes can be satisfactorily achieved by self-governance.
- 1.1.4 We also think there is little prospect of the GTAC evolving in a satisfactory manner as some of our core issues relate to the structure of GTAC as an industry agreement.
- 1.1.5 We observe that the industry appears to have been given an extraordinarily long time to achieve the outcomes set out in successive GPSs that gas industry participants are able to access transmission pipelines on reasonable terms and conditions.
- 1.1.6 We note the GIC has decided² not to recommend gas governance rules or regulations for a transmission access arrangement to date.
- 1.1.7 The purpose of this letter is to raise a number of concerns with the Gas Industry Company Limited (**GIC**) that we have identified with the GTAC, including as part of our recent legal review, and seek to work directly with the GIC to determine how a reasonable transmission access outcome could be achieved.

¹ ACIL Consulting: *Review of the New Zealand Gas Sector. A Report to the Ministry of Economic Development*, October 2001

² The GIC have stated that they have no present intention of recommending rules or regulations. A regulated solution will only be considered if the negotiated industry solution has been completely exhausted and no outcome has been achieved.

2 Process to date has failed to address our issues

- 2.1.1 In the process to date with First Gas, we have queried whether some of the commercial terms, such as the proposed Priority Rights (**PR**) arrangements, are reasonable in the context of a gas industry participant serving the retail market and requiring access to reasonably priced firm capacity.³
- 2.1.2 Our commercial design issues have either not been addressed in the current version of the proposed GTAC or have been set aside for consideration at a later time⁴.
- 2.1.3 As part of our engagement with First Gas we have also raised a number of issues about the proposed governance and compliance structures for the new transmission access arrangement.
- 2.1.4 We thought a more efficient process would have been to consider governance and compliance matters in parallel with the commercial design of the new access regime.
- 2.1.5 However our views have been disregarded in favour of continuation of the current legal structure (which favours the pipeline owner). No other options were offered.
- 2.1.6 In our view the proposed legal structure does not provide a reasonable basis of access to the transmission network.
- 2.1.7 The ongoing reticence of First Gas to address these substantive issues has resulted in our losing faith that the current process will provide reasonable access to the gas transmission system.

3 Consultation process for last stages of GTAC design is sub-optimal

- 3.1.1 The consultation process for the last stages of the development of the GTAC is in our view sub-optimal and will not afford shippers and other interested parties with an opportunity to review substantive changes that might be made prior to submission to the GIC.
- 3.1.2 There is only very limited time anticipated to be provided for review of the appropriateness of any changes following from the November workshops (as indicated in the email from First Gas on 23 November) and no contemplation of consulting on any material changes resulting from the current round of consultation.
- 3.1.3 We expect First Gas, at a minimum, to develop some arrangements for transition into the new GTAC. For example to implement the code change process in advance of the anticipated 1 October 2018 commencement.
- 3.1.4 These arrangements will require consultation with industry to ensure that they are fit for purpose.

4 Nature of the GIC's functions

- 4.1.1 The GIC's constitution provides that the principal purpose of the Company is to perform the functions and exercise the powers of an industry body under Part 4A of the Gas Act.
- 4.1.2 The Gas Act authorises the Minister to set by means of a GPS, the objectives and outcomes that the Government wants the GIC to pursue in relation to the governance of the gas industry and against which the GIC must report.⁵

³ We see significant risk in price discovery via an auction process where we have to compete for a firm capacity access product against shippers with considerable market power.

⁴ For example the design of the PR auction arrangements has been delayed until 2018.

⁵ Section 43ZO

- 4.1.3 The 2008 GPS includes a stated outcome that gas industry participants and new entrants can access transmission pipelines on reasonable terms and conditions⁶.
- 4.1.4 As we see it, there are two broad options for making pan industry arrangements, such as a pipeline access arrangement, enforceable:
- a) implement gas governance regulations or rules under the Gas Act; or
 - b) use a contract mechanism where compliance with certain pan industry “rules” is a condition of access to pipelines.
- 4.1.5 The GIC’s power to recommend gas governance rules or regulations must be exercised in the prescribed manner, which includes consideration of all reasonably practicable options for achieving the regulatory objective, consultation, cost benefit analysis and a consideration of market facilitation alternatives including education, information and voluntary compliance options⁷.
- 4.1.6 Relevantly we note that there does not appear to be a preference in the Gas Act for a contract based industry agreement or Codes as opposed to regulations or rules where an arrangement needs to be mandatory.
- 4.1.7 It is simply a question in each case of selecting the best mechanism to achieve the desired GPS outcomes.

5 Access facilitation role

- 5.1.1 The GIC has decided to take on industry agreement facilitation roles (e.g. in relation to rule changes) under MPOC and the VTC and now GTAC.⁸
- 5.1.2 Any such role is clearly secondary to its primary duty to pursue the outcomes required by the GPS.
- 5.1.3 As part of its current facilitation role the GIC intends to endorse, i.e. independently assess, the GTAC using an “*overall materially better than the status quo*” criteria⁹. This criteria has been incorporated in the MPOC as part of the Termination Code change request. In practice this means that the GTAC will effectively be given effect to via imposed replacement access terms.
- 5.1.4 The GIC’s analysis of how the Gas Act and GPS objectives might apply to transmission pipelines access was outlined at the 10 November workshop, where a number of worked examples of how the GIC intends to assess the GTAC were presented.
- 5.1.5 It became clear during the presentation that the GIC considers it is sufficient for First Gas to present an industry agreement that is only materially better at meeting Gas Act and GPS objectives and outcomes than the current arrangements, and not necessarily an agreement which offers shippers “*reasonable terms of access*”.
- 5.1.6 We do not consider that the GIC’s duties under the Act, as outlined above, will be met if it simply determines that the terms proposed by First Gas are materially better than the current access terms at meeting the Gas Act and GPS objectives and outcomes.
- 5.1.7 These duties will only be met if the GIC determines that the terms and conditions of access are reasonable.

⁶ GPS on Gas Governance (April 2008).

⁷ Section 43N

⁸ The GIC is permitted by its constitution to undertake industry roles under existing agreements. It is not however entirely clear whether this permission extends to making a decision to replace the entire MPOC and VTC with the GTAC.

⁹ There is no statutory basis for using the materially better assessment criteria, which appears to have been adopted from the statutory threshold in the Commerce Act for changing input methodologies

5.1.8 Moreover we are concerned that the GIC will not be able to impartially advise the Minister that pipeline access is available to industry participants and new entrants on reasonable terms if it has been an integral part of a process applying a different approval criteria.

6 Approach to assessing if access terms and consideration are reasonable

6.1 Market context

6.1.1 The proposed commercial terms of GTAC need to be assessed in the context of the structural issues of the NZ gas market which has high levels of market concentration and vertical integration.

6.1.2 The issues with the concentration of the NZ gas market have been acknowledged for many years, as evidenced by the recommendation of the Allen Consulting Group in 2006¹⁰.

“In our view, the next GPS could:

...

- *Provide for a two yearly cycle whereby the industry body could”*

...

- *Formally assess the gas industry in terms of its market concentration and barriers to entry and exit;*
- *Monitor progress of market developments and level of competitive activity;*
- *Revise the industry’s strategies and priorities for on-going developments, which would form the basis of the industry body’s strategic plan;*
- *Report competition outcomes with an expectation of incremental improvements.”*

6.1.3 The more recent International Energy Agency’s NZ 2017 review¹¹ noted that the upstream gas market in NZ continues to be *“small and concentrated, involving a small number of producers and wholesalers, relying on mainly bilateral contract arrangements.”*

6.1.4 It is concerning that these structural issues have been largely ignored during the design process for the GTAC arrangements to date.

6.1.5 It is vital that these structural issues are taken into account in designing the transmission access arrangements in order to ensure that access is being afforded on *“reasonable terms and conditions”*.

6.2 Evidence of reasonableness

6.2.1 To date we do not consider that there has been any evidence provided that the terms and conditions developed by First Gas under the GTAC will meet the reasonable terms threshold. We think this should be a pre-condition of the GIC’s support for an industry agreement.

6.2.2 For example, in considering whether barriers to entry are minimised the test contemplated by First Gas is simply that entry is more likely to occur after the change than before. There is no consideration of whether the terms and conditions (and risk allocations) imposed by First Gas (a monopoly) are reasonable.

¹⁰ Allen Consulting Group (2006) – The NZ gas industry in 2006 - review of its state and performance, page xii.

¹¹ Refer to page 42.

6.2.3 Likewise there has been no discussion around whether the proposed mechanism for providing access, i.e. continuation of mirror bilateral contracts which incorporate codes by reference, is more reasonable than regulated terms and conditions. This is the test that needs to be met in order for the GIC to meet its duties under the Act.

7 Trustpower considers the proposed commercial terms are not reasonable

7.1 Standard access terms

7.1.1 Trustpower is seeking access to the gas transmission system on terms which are reasonable for an industry participant operating solely in the retail sector with a small market share.

7.1.2 First Gas has acknowledged that the needs of retail customers are different but has not offered us a suitable access product for serving this segment of the market, despite a number of requests to this effect.

7.1.3 Instead of an affordable firm access product which matches our supply obligations, First Gas proposes that we obtain firmer access rights via Priority Rights entitlements.

7.2 Priority Rights

7.2.1 In our view the proposed Priority Right arrangements create:

- a) Un-manageable risks for gas industry participants operating solely in the fixed-price, variable-volume retail market as they do not offer firm capacity at a known price. While these risks may exist under the current VTC arrangements, we do not consider it is reasonable to:
 - enshrine a known design deficiency into the GTAC which distorts signals and treats mass market customers differently to under the CCM Regulations; and
 - expose shippers of mass market customers to increased cost/risk exposure if they miss out on Priority Rights given there is no way for them to manage the risks associated with congestion arising, i.e. mass market customers cannot curtail consumption in response to a signal that congestion is occurring and so the relevant Shipper will be exposed to financial penalties associated with overruns and any liability that could arise.
- b) Significant potential for gaming the PR auction process and outcomes by other industry participants. While these issues may yet be addressed within the auction design, neither the GIC nor shippers can be confident that these mechanisms will be reasonable at this time.
- c) Limitations on competition for customers. There needs to be a link between Priority Rights and a load created or else competition for these customers will be limited¹². We consider it is not reasonable to establish arrangements that could limit competition within the retail gas market.

7.3 Level of discretion afforded to First Gas

7.3.1 We have also drawn attention to the fact that the level of discretion afforded to the pipeline owner creates an ongoing opportunity to shift transmission risk from the pipeline owner to shippers and their customers.

¹² For example, following an auction a customer could wish to switch to a new retailer, but that new retailer may not be able to acquire appropriate Priority Rights for that customer from its incumbent provider, or another Shipper in the area, and so not be able to secure the switch. We note this issue has been raised on a number of occasions by Greymouth Gas.

- 7.3.2 Concerns about the significant level of discretion afforded to First Gas under the GTAC are commonly held by all shippers, as captured in the email of common shipper concerns dated 8 November.
- 7.3.3 While at the 10 November workshop shippers and First Gas worked through the appropriateness of the discretion currently provided under a number of clauses of the GTAC, there will be no clarity provided as to how First Gas will take into account the feedback prior to the final GTAC going to the GIC for approval.
- 7.3.4 Likewise there is no certainty as to how those areas outside the current drafting of the GTAC which provide significant discretion to First Gas, i.e. the development arrangements for the PR auction, will be addressed.
- 7.3.5 As a result there still remains significant uncertainty as to whether the discretion afforded to First Gas under the GTAC will be reasonable.

7.4 Rebates

- 7.4.1 As raised at the 17 November workshop, we are troubled by the proposed rebate arrangements presented in the second draft of the GTAC, including with respect to the rebate of certain transmission charges.
- 7.4.2 While we appreciate that it would introduce a similar rebate methodology to that applied under the current MPOC and VTC, the change:
- a) represents a significant amendment from the previous version of the GTAC;
 - b) has been introduced at a late stage in the GTAC design process based on the recommendations of one (large) Shipper during the last round of consultation and has had limited discussion with broader industry to date;
 - c) would favour larger shippers through the return of monies each month based on the basis of volumes transported; and
 - d) distorts the incentives under the GTAC, including around ensuring accurate daily nominations and the need to procure Priority Rights¹³.
- 7.4.3 We therefore do not think the proposed arrangements are consistent with the objectives and outcomes sought in the Gas Act and GPS.

7.5 Contract favours incumbents

- 7.5.1 As noted earlier, these commercial concerns are exasperated by the structural issues of the NZ gas market.
- 7.5.2 The effect of these arrangements is that the incumbents are advantaged and that the barriers to entry are raised for new entrants and participants with smaller market share, which is contrary to the Gas Act and GPS objectives and outcomes.

¹³ The current drafting of the rebate arrangements has money being returned based on daily approved nominations. This favours larger shippers, and also mutes the signal for larger shippers to acquire Priority Rights. In particular, larger shippers will have a lower willingness to pay for Priority Rights as they can take solace in the knowledge that they will receive a larger portion of the rebates than a smaller Shipper. This tilts the structure of PRs, and the under/over-run incentive fees in favour of the larger shippers.

8 Our legal review has highlighted other elements are not reasonable

8.1 Legal vehicle is not fit for purpose

- 8.1.1 The GTAC is a bilateral agreement between each shipper and First Gas for access to the First Gas transmission pipeline. The GTAC becomes binding on shippers when they sign a Transmission Services Agreement (**TSA**).
- 8.1.2 A TSA provides that each party agrees to comply with and be bound by the terms and conditions of the GTAC (as amended from time to time) as if those terms were set out in full in the TSA.
- 8.1.3 We note that TSAs are only part of the picture. Interconnection obligations for those who have physical connection to the pipeline such as gas producers, gas processors, pipeline or distribution networks are set out in further bilateral interconnection agreements (**ICAs**).
- 8.1.4 Non-standard bilateral agreements (called Supplementary Agreements in the GTAC) are also provided for. They supply capacity to a specific end user on bespoke terms – in other words they vary the GTAC.
- 8.1.5 This bilateral agreement structure puts the pipeline owner in a key role as the common counterparty.
- 8.1.6 However in our view bilateral industry agreements are not the best option for an arrangement which involves multiple counterparties making common commitments.
- 8.1.7 We note the use of an industry agreement structure was not preferred by the GIC for pan-industry switching, downstream reconciliation or critical gas contingency arrangements.
- 8.1.8 We struggle to see why transmission access is considered a suitable candidate for an industry agreement when those arrangements were not.

8.2 The dispute resolution process is inferior to that which could be obtained under regulated terms

- 8.2.1 TSAs are published so the parties to the “mirror” bilateral contracts are publicly known. However, this “mirror bilateral contract + incorporated common code” structure does not create a legal right to enforce the terms and conditions of the GTAC on other shippers.
- 8.2.2 There are a number areas of the GTAC where the actions of a party other than First Gas could affect a Shipper, i.e. another Shipper or Interconnected party. These include:
- a) PR Auctions;
 - b) The execution of PR holdings for delivery on a day;
 - c) The overrun of another Shipper¹⁴;
 - d) The rebates regime (explored earlier);
 - e) Compliance with prudential requirements;
 - f) The provision of accurate metering information for D+1/reconciliation;
 - g) Maintaining the quality of gas in the pipeline¹⁵; and

¹⁴ For example another Shipper going into overrun could result in our nomination for transport of gas being displaced, forcing us to incur overrun fees.

¹⁵ A producer inserting non-specification gas could potentially have implications for customer’s appliances etc.

- h) The requirements for transparency of information¹⁶.
- 8.2.3 Under the bilateral contract structure:
- a) any enforcement of the Code against another Shipper is dependent on First Gas who may not always have the incentives to take enforcement actions against its customers.¹⁷
 - b) the process for resolving disputes between First Gas and a Shipper requires resolution by an independent expert or arbitrator. This could be a very expensive and long-winded process against a determined pipeline owner.
- 8.2.4 Monitoring of behaviour by an independent entity that can take enforcement action is optimal to ensuring competitive outcomes eventuate given the market concentration issues.
- 8.2.5 We note a low-cost and effective compliance and monitoring regime could readily be put in place under regulations under the Act.
- 8.2.6 We think it would be preferable if all parties could have access to the compliance arrangements set up for switching, downstream reconciliation and critical contingency management.
- 8.2.7 In recommending the Minister that critical contingency management regulations be established, the GIC noted that *“an effective compliance regime is crucial to ensuring the proposed regulations achieve their purpose”*¹⁸ and that *“it is important that compliance be achieved in the most efficient manner possible.”*¹⁹

8.3 Rule change process does not guarantee reasonable terms of access

- 8.3.1 The code change process for the GTAC arrangements involves an assessment by the GIC against the objectives in the Act and the GPS.
- 8.3.2 The criteria does not include the outcome in the GPS that industry participants can access transmission pipelines on reasonable terms and conditions.
- 8.3.3 As a result, we consider that the GTAC arrangements are likely to be inferior to regulated access terms and this will continue over time.
- 8.3.4 We also note that there is no ability for a party to have a decision by the GIC with respect to a code change reviewed on a procedural or merits basis.
- 8.3.5 Trustpower has previously highlighted the issues around the GIC’s independence and the public law risks associated with having a decision-maker appointed and funded by the industry determining rule changes.
- 8.3.6 Having a Minister approve gas governance rules recommended by the GIC provides an additional protection against these risks.

8.4 The Commerce Act risks are significantly greater under industry agreement

- 8.4.1 In addition we note that it is conceivable that one or more of the provisions in a gas access code addressing matters such as:
- a) the nominations process

¹⁶ For example a gas producer not providing First Gas with information around planned and unplanned outages could result in asymmetric information being available and result in a Shipper incurring unnecessary expenses.

¹⁷ Previously the incentives pool under the VTC enabled a mechanism for redress if one Shipper’s actions impacted on another Shipper

¹⁸ Recommendation to the Minister of Energy on Critical Contingency Amendments to Gas Compliance Regulations (June 2008), GIC, page 1.

¹⁹ Recommendation to the Minister of Energy on Critical Contingency Amendments to Gas Compliance Regulations (June 2008), GIC, page 9.

- b) energy allocations
- c) balancing
- d) curtailment
- e) congestion management
- f) fees and charges
- g) code change process
- h) prudential requirements

could breach the restrictive trade practice provisions of the Commerce Act (sections 27 or 29) or involve costly and time consuming applications for authorisation of the arrangements before parties can sign the contract.

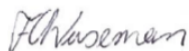
- 8.4.2 This includes authorisation applications by any dissatisfied shipper, such as occurred in 2005 when Nova challenged the lawfulness of certain elements of the MPOC.
- 8.4.3 There is also a risk that shippers breach section 80 of the Commerce Act if they aid, abet, counsel or procure another person to contravene the Commerce Act or are knowingly concerned in or party to the contravention of the Commerce Act by another person.
- 8.4.4 These risks do not apply to regulated terms of access which are deemed authorised under the Commerce Act (s43ZZR). Alternatively these risks could be mitigated by the GIC or First Gas seeking authorisation of the GTAC, or an exemption from authorisation, on behalf of industry.

9 Concluding remarks

- 9.1.1 In addition to the individual terms of access, the GIC also needs to consider if the process it is asking shippers to follow is reasonable and whether the mechanism by which the arrangement becomes binding on shippers is fit for purpose.
- 9.1.2 We are concerned that the industry will work through this lengthy consultation process to develop a GTAC which is materially better than the MPOC/VTC, only to find at the very end of the process there is a further step which it might fail, namely an assessment of whether the reasonable access terms threshold is met.
- 9.1.3 We have looked at the history of GIC initiatives on transmission access and that history does not inspire us that an industry agreement process will deliver the desired access arrangements. A precis of our evidence for that view is set out in the time line in Appendix A.
- 9.1.4 We would be keen to meet directly with the GIC to discuss how these concerns can be alleviated.

For any questions relating to the material in this submission, please contact me on 027 549 9330.

Regards,



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SENIOR ADVISOR STRATEGY AND REGULATION

Appendix A – The steps taken by the GIC to date to ensure transmission pipelines can be accessed on reasonable terms (as reported in its Annual Reports)

