



Submission on Options for Vector Transmission Capacity

From

Contact Energy Limited

Introduction

Contact welcomes the opportunity to provide feedback on this consultation paper. A general commentary and responses to the questions raised in the consultation paper follow.

For any questions related to this submission, please contact:

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Summary

Contact Energy Limited (“Contact”) supports the efforts of the Gas Industry Company (“GIC”) in facilitating industry discussion on gas transmission capacity arrangements.

Contact is a major user of existing gas transmission capacity assets, and views the issues around capacity as potentially restricting the value of the integrated supply chain for gas.

As such, Contact believes that capacity arrangements should provide appropriate signals to infrastructure owners, ensure that pricing is efficient and that an appropriate level of service is provided in order to facilitate growth of the gas market and associated energy markets.

Given the scope of these issues, Contact believes it is important that the GIC’s work is put in context of the regulatory considerations of pipeline services being undertaken by the Commerce Commission. It is important that the roles of the various regulatory bodies and their mandates in addressing these issues are made clear.

Gas transmission capacity as part of an integrated supply chain

The market for natural gas is necessarily an integrated one. The extensive value chain from exploration and production to end use customer contains a number of high value components, as well as being reliant on, and influential upon, a number of associated energy markets.

Successful international gas markets have sought to maximise collective value from this integration. While there are key differences (particularly in terms of scale and maturity) between markets in the USA and Brazil and New Zealand for example, their key features provide useful guidance in seeking to grow our own market.

The availability and pricing of gas transmission assets is key to this integration, and hence the role of Vector’s assets is an important one.

Providing for upstream developments to reach market

Exploration and production of hydrocarbons is heavily capital intensive, and gas transmission provides essential security for owners of upstream assets and the markets they supply. Both existing and new gas transmission infrastructure will be essential in bringing gas from a wider variety of fields to market than has traditionally been the case in New Zealand.

Transmission for thermal generation

Gas will continue to play a vital role in electricity generation in New Zealand, particularly in supporting weather dependent renewables. Equitable arrangements for access to (and pricing of) transmission capacity will be vital in ensuring these plant can contribute to the ongoing security of supply requirements of the country. Given the long-life nature of thermal generation assets, the transmission requirements are ideally also long-term.

Gas for industry and home use

New Zealand has a relatively large base of gas consuming assets in industry, with others having dual fuel capability. There are a number of large industrial users in the vicinity of the North Pipeline who are seeking, or would potentially use, additional transmission capacity if it were available on a basis to support long term use as a fuel or feedstock.

The Government has also expressed its desire to promote direct gas use¹ and there is likely to be ongoing demand at a retail level for gas, particularly in areas fed by the North Pipeline.

Importance of efficient capacity arrangements – a user perspective

Contact has a large fleet of existing thermal generation capacity, and is currently supplementing that fleet with new gas fired peakers in Stratford. Contact expects that there will be an ongoing need for thermal generation in the electricity market, including in a role supporting weather dependent renewable generation.

Similarly to other large users, the surety around access to, and pricing of, gas transmission capacity is very important and pricing in particular can be an important contributing factor in decisions around potential plant location. With both existing and potential new build options for thermal generation in the upper North Island, Contact expects its demand for capacity to be a key driver of requirements for transmission capacity on the North Pipeline.

¹ For example in the 2008 Government Policy Statement on gas, the Minister requested that the GIC investigate policies to enhance direct use of gas.

Given the long-life nature of the gas fired assets Contact is developing, and could potentially develop, it is expected that the incentives on Vector to invest in new capacity should align at a high level with Contact's. There are a number of other major gas users (e.g. dairy manufacturing, fuel processing) whose desire for long term certainty is likely to be similarly driven by long-term capital investments and/or requirements for price certainty of gas transmission as an input.

Issues with existing arrangements from a Contact perspective

The issues around access to capacity on the Vector network (particularly in relation to the North Pipeline) suggest that the existing arrangements in place are not ideal; at a minimum, it appears the requirements of Vector's customers are not being fully met under these arrangements.

It is difficult to accept that the current capacity conditions have developed to the point where near-term risks are material. While it is accepted that Vector has identified the issue in some of its publications, the risks (as we understand them) would seem to have warranted more attention and progression given the potential impact on existing and new demand for gas on the North Pipeline.

Given our underlying requirements as noted above, Contact has concerns with a number of aspects of the current arrangements, including those outlined below.

Capacity planning process and issuance

The process Vector undertakes for planning capacity is not sufficiently clear to customers. Customers are not easily able to identify the tradeoffs Vector is making when identifying capacity for allocation, and whether all available capacity will be accessible.

The current constraints are also likely to mean that Vector acts conservatively in issuing capacity on an annual basis in order to avoid instances where it may not be able to meet its commitments to users.

Certainty for existing major users & risks associated with grandfathering

There is no certainty for existing users who are coming off long-term contracts. This issue is accentuated during periods where capacity is constrained, as these users will have no

certainty that their existing capacity will still be available at acceptable prices (and with appropriate terms and conditions). For users with long-life assets, this is a material risk.

This issue is expected to be further exacerbated as a result of grandfathering rights, as users may be more conservative in terms of foregoing those rights; especially when underlying capacity is tight. This will impact on the allocative efficiency of capacity across the market; those who hold capacity may value it less than others without capacity. This has the potential to inhibit competition in the retail market.

Structure of existing contracts

The existing arrangements only provide for either firm or fully interruptible contracts. Because of the current risks and difficulties associated with transferring capacity in the North Pipeline, there is risk that the contracting options available to existing and new users are not ideal. The inability to easily secure short term capacity is a major hindrance in trying to grow gas demand.

Operational uncertainty

As well as providing medium and longer-term uncertainty, the current arrangements also create some operational uncertainty. The 2 year life cycle of the Vector Transmission Code (“VTC”) means that users face risk that the operational management of Vector’s pipeline capacity could change relatively frequently.

Demand forecasting and uncertainty

Some of the material provided by both the GIC and Vector identifies difficulties with forecasting demand for gas, and how this is likely to constrain the ability to build transmission capacity (to some extent). Vector has noted it requires the following conditions before it would invest²:

- *satisfactory outcome in respect of key Inputs Methodologies*
- *adequate protection against asset stranding*
- *demonstrated customer support*
- *revenue certainty*

Vector is well placed to understand the tolerances and limits of its own assets, and it should have the most detailed picture of gas demand in the area covered by the North Pipeline

² Vector Network Solutions. North Pipeline: Winter 2010 (& Beyond) , March 2010, page 23.

(certainly in terms of existing use). It is accepted that appropriate mechanisms need to be in place for expected gas demand to be communicated to Vector, but there will always be risk around what level of demand will actually eventuate. In this regard, its stated requirement for adequate protection against asset stranding seems unrealistic, unless pricing to users reflected the shift in risk away from the party probably best placed to manage it (Vector).

The risk Vector is apparently seeking to avoid seems analogous to the normal commercial risk faced by many parties investing in long-life assets. Contact continues to build generation assets even though demand is changeable. Contact does not believe demand uncertainty is a suitable justification for the capacity position taken by Vector³ - certainly not to the extent that protection against asset stranding is justified.

Comments on the specific options put forward

Evaluation criteria

Contact is broadly comfortable with the high level amended evaluation criteria proposed.

Contact notes though, that while the criteria are useful, it is difficult to judge the relative merits of the proposals without guidance as to the weightings of the various criteria. For example, while the transition costs from current arrangements is important, if the regime being implemented is a significant improvement, but requires relatively large transition costs, it may still be beneficial to implement it. In saying this, Contact recognises the nature of the paper as being for discussion purposes. Clearly full cost benefit analysis of proposals would be required before any specific proposal could be selected for progression.

Current arrangements

Contact has provided its thoughts on the current arrangements above. Contact's views on the current arrangements are broadly in line with those summarised by the GIC, however Contact does not support the proposal that investment is likely to be inefficient partly because of the lack of good information on demand.

Contract carriage

Contact does not support the GIC's proposition that there could not be a liquid secondary market for capacity. This is important as it sets the scene for the number of the evaluations

³ Vector modelling has indicated that if reticulated load reaches levels of winter 2006, new predicted loads in Auckland eventuate, Southdown and Otahuhu B operate at capacity then the pipeline will be running at capacity from a survival time perspective. (Vector Network Solutions. North Pipeline: Winter 2010 (& Beyond) , March 2010)

against individual criteria for this option. Contact believes that the appropriate mechanism would incentivise some providers to purchase additional capacity, and potentially re-package it to provide services which users demand, if they are not provided by Vector. If the pricing of capacity is appropriately set, then users should be incentivised to drive a secondary market. Contact does not believe that the current market provides a useful analogy for determining whether a secondary market would be successful, as while reserved capacity can be traded it is often the case that the balance of capacity for sale/being sought is asymmetric at any particular point in time.

Contact supports the GIC statements that contract prices should reflect the marginal costs of expansion, but disagrees that a contract carriage model would lead to inefficient allocation. This is solely driven by the statements around the likelihood of a secondary market, which are not supported. While the GIC notes that the current arrangements provide for annual and mid-year variations, major users are likely to prefer the certainty of longer term arrangements, and are likely to be willing to take on risk when rewarded via prices that reflect a longer term commitment. The mechanism should be designed to reflect the relative requirements of users.

Contact believes that contract carriage could potentially help promote retail competition where increased capacity provided for packaging of capacity products to new entrants; certainly more than would be the case with a capacity shortage. Contact notes that it seems unreasonable to highlight issues around capacity shortages till new investment occurs (under this option), given that there will be delays under all the options until investment occurs.

In general, Contact believes that the contract carriage option is more appropriate than the GIC evaluation suggests (particularly in relation to efficient investment, allocation and facilitation of competition), and that the evaluation is driven by unsupported views on the likelihood of a secondary market. The current level of concern raised by businesses seeking higher levels of firm capacity than currently exist would seem to confirm this.

Common carriage

While a common carriage mechanism is likely to be beneficial in allocating physical capacity in a market where there is already spare capacity (as on the Maui pipeline) it is unlikely to be as beneficial in a market such as is the case now (in terms of the North Pipeline) where capacity is lower than that sought by users.

Contact does not support the GIC evaluation with regard to efficient allocation, as it is likely that a user who values certainty and term highly may not be able to secure this under a common carriage system, unless there is already sufficient spare capacity. As with the contract carriage option, the mechanism for managing capacity should reflect the relative requirements of users. Given that major users are likely to prefer firm capacity this would suggest that the benefits the GIC identify may be overstated and that the ranking for efficient investment may also be overstated compared to the counterfactual.

Overall, a mechanism based solely on common carriage that is introduced into a market with existing shortfalls in capacity is unlikely to be as suitable as is suggested by the GIC evaluation. While it will provide an efficient allocation of physical capacity (in the short term) the lack of certainty (price and capacity over a long period) is likely to be a significant issue for major users with long-life assets seeking certainty.

Hybrid option

The hybrid option seems useful in providing the certainty of firm capacity that major users are likely to require, while providing some scope for other users to effectively have common carriage on the remaining capacity. This would be a useful option when supported by suitable performance standards.

Contact's major concern with this option would be ensuring that it still provided the appropriate signals for Vector to undertake long-term investments in building capacity where appropriate.

Similarly, Contact is unclear as to how the rating of 'good' is applied to the efficient investment criteria for the hybrid option, when the contract carriage option rated 'very poor'. Under both options, major users will effectively be driving the investment so it is not clear why the difference between options is marked for this criterion. It may be the case that the ability to facilitate competition is therefore overstated in the GIC evaluation for the hybrid option.

Overall Contact supports concepts such as the hybrid option, but does not believe some of the evaluation results proposed by the GIC are appropriate; particularly as compared to those for the contract carriage option.

MDL carriage option

Contact believes that there are useful concepts that can be gleaned from the MDL carriage option, in terms of a balance between firm and effectively common carriage.

Overall Contact believes that the MDL carriage option (as evaluated by the GIC) may not compare favourably to the hybrid option largely because of the potential for the hybrid option evaluations for some criteria to be overstated (as noted above). The option is therefore likely to have more merit than what is proposed in the GIC evaluation.

Incremental change option

Contact is unclear as to the certainty of the benefits identified under the incremental change option. Contact believes that the issues around assigning capacity to customers will exceed the benefits of doing so. It is unlikely that there will be many users willing/able to manage their own capacity.

Contact does not believe that the incremental change option is worthy of further consideration. The issues with the existing arrangements would suggest that more of a shift away is required in order to meet both the needs of Vector and of users.

GIC next steps

Contact believes it is useful for the GIC to be encouraging debate on transmission capacity issues, and to encourage industry resolution before regulatory intervention.

Contact believes it would be useful to have any next steps developed considering both Vector and Maui transmission assets, particularly as any difference in capacity arrangements (and pricing structures) will be an important factor in ensuring any intervention is optimised.

Importantly though, Contact believes that any next steps need to be put in context of the regulatory considerations of pipeline services being undertaken by the Commerce Commission. It is important that the roles of the various regulatory bodies and their mandates in addressing these issues are made clear.

Conclusions

Issues with existing arrangements

As a major existing user of gas transmission assets, and a participant with potential need for additional capacity, Contact is concerned that the current arrangements have resulted in a shortfall between the capacity that users require, and the level of capacity available. It seems unlikely that the arrangements meet the need of existing users, or provide for the efficient

allocation of transmission capacity. They do not appear to provide the appropriate platform to allow the gas market to grow, and for the value of the gas supply chain to be maximised.

GIC options

In this regard, Contact is pleased that the GIC has produced its “Options for Vector Transmission Capacity” paper. Contact agrees that more needs to be done to address the incentives to invest in new capacity, but also to ensure that the access to, and pricing of, transmission capacity is established in a way that provides for the long-term benefits of consumers. Contact reaffirms the importance of any regulatory involvement being well coordinated in addressing these issues.

Contact supports concepts such as the hybrid option which acknowledge the need for certainty for large users (backed up by effective performance standards that ensure new capacity is build to meet demand), with the ability for remaining capacity to be efficiently allocated to smaller users. Contact also believes the contract carriage model is worthy of further investigation, as its key elements align with the needs of major users in terms of certainty. Elements of the common carriage model also have benefits, but these may be constrained in our market where capacity is already short.

Need for Vector input to discussion

While the GIC notes (appropriately) that Commerce Commission decisions around the regulatory arrangements to apply to Vector under the Commerce Act are yet to be finalised, Contact believes that this should not stop Vector offering its views on what needs to occur for efficient capacity arrangements to be put in place; even at a high level.

While there is clearly regulatory uncertainty, the scope of the likely regulatory framework is not entirely unpredictable (at least at a high level), and the conditions Vector are likely to require should fit under most of the ‘likely’ regimes that could be proposed. Without Vector doing so, there is risk that the level of regulatory intervention could be greater than may be required.

Vector has noted that they are producing a series of papers on capacity options; we await their release.

It is also important that there is better coordination of the regulatory bodies so that issues associated with price and quality of service are addressed to best meet user’s needs. This

includes the clear identification of jurisdiction to allow any industry based options to be developed.

Specific answers to Questions

No	Question	Contact Energy response
Q1	Do you think the objectives identified in section 5 are appropriate criteria for evaluating transmission capacity options?	<p>Contact is broadly comfortable with the high level amended evaluation criteria proposed.</p> <p>Contact notes though, that while the criteria are useful, it is difficult to judge the relative merits of the proposals without guidance as to the weightings of the various criteria. Full cost benefit analysis of proposals would be required before any specific proposal could be selected for progression.</p>
Q2	Do you agree with the evaluation of the current capacity arrangements?	See our specific comments on the current arrangements under the “Comments on the specific options put forward” section in the body of this report.
Q3	Do you agree with the evaluation of the contract carriage option?	See our specific comments on the contract carriage option under the “Comments on the specific options put forward” section in the body of this report.
Q4	Do you agree with the evaluation of the common carriage option?	See our specific comments on the common carriage option under the “Comments on the specific options put forward” section in the body of this report.
Q5	Do you agree with the evaluation of the hybrid option?	See our specific comments on the hybrid option under the “Comments on the specific options put forward” section in the body of this report.
Q6	Do you agree with the evaluation of the MDL carriage option?	See our specific comments on the MDL carriage option under the “Comments on the specific options put forward” section in the body of this report.
Q7	Do you agree with the evaluation of the incremental change option?	See our specific comments on the incremental change option under the “Comments on the specific options put forward” section in the body of this report.
Q8	Do you agree that only the hybrid and incremental change options should be consider further?	No. Contact believes the hybrid and contract carriage options should be considered further. These, and the MDL and common carriage options could be further developed via a cost benefit analysis, as it is unclear as to the real relative benefits based on a subjective evaluation.
Q9	Do you agree with the proposed next steps?	Contact believes it is essential that any next steps take into account the wider regulatory considerations of pipeline services via the Commerce Commission. It is important that the roles of the various regulatory bodies and their mandates in addressing these issues are made clear.