Submission on statement of proposal: Retail competition and transmission capacity

From

Contact Energy Limited

Introduction

Contact Energy Limited (“Contact”) welcomes the opportunity to provide feedback on the “Retail competition and transmission capacity: Statement of Proposal” (“SOP”) issued by the Gas Industry Company (“GIC”). A general commentary and responses to the questions raised in the SOP follow. Page references identified relate to the SOP.

Contact has significant concerns about the SOP and its conclusions. Contact notes that the issues, comments and suggestions identified in our submission “Options for Vector Transmission Capacity” (May 2010) are still relevant and applicable to this issue.

Contact would like to meet with representatives from the GIC to discuss our submission, and the GIC’s proposed next steps.

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Summary

Contact believes that the SOP is deficient to the extent that it should not be provided to the Minister in its current state.

Contact believes that there is considerable work to be done by the GIC to make a compelling case that:

- a short term market failure exists in relation to transmission capacity;
- there is a 'competition' issue (or that, if there was one;
- the GIC is the appropriate body to address concerns relating to competition);
- there is quantitative justification for regulatory intervention;
- the options identified in the SOP are appropriate (and exhaustive) for the defined problem;
- non-regulatory options are not feasible;
- the proposal does not conflict with Gas Act objectives, and that the detriment to holders of existing property rights is appropriate and reasonable; and
- the proposal is likely to produce net benefits based on robust cost benefit analysis.

Contact is keen to work with the GIC to address its concerns that led to the SOP.

Problem definition

A clear definition of the relevant problem or market failure is an essential step in any process which recommends regulatory intervention; especially where the failure is short-term in nature and the regulation involves expropriation of property rights.

Contact is therefore disappointed by the lack of robustness in the GIC assessment of the problem underpinning its preferred solution, which appears to confuse physical and commercial issues with an unsubstantiated 'competition issue'.

Lack of a clear definition of the problem appears to be one of the main reasons why the GIC has not provided the cost benefit analysis required by the Gas Act.

Reasons for the constraint

The information relied on by the GIC surrounding the level of physical constraint on the North Pipeline appears to be limited and, potentially out of date. The SOP describes conditions under which Vector identified capacity would be constrained, which are largely driven by the level of operation of the Southdown and Otahuhu power stations (the '2006 cold winter demand scenario'). The GIC notes that:

"Gas Industry Co has made reasonable enquiries of Vector about the extent of the capacity constraint. This paper assumes Vector's judgement to issue no more Reserved Capacity on its North Pipeline is correct" (p.2).

Given that the GIC is recommending a solution involving significant short-term regulatory intervention, its investigation must go beyond "reasonable enquiries", including ensuring that these estimates are contemporary and robust. Given the changes observable in gas demand in recent years, the assumptions underlying the estimates may well be inaccurate. This assessment is pivotal in identifying the nature and likely duration of any capacity constraint that may or may not exist.

There is a wealth of data available on daily gas flows at all receipt points and delivery points on the North Pipeline. This data should be used to develop an understanding of how the North Pipeline is used and to independently ascertain whether Vector's decisions around access to capacity are justified.

The GIC's willingness to simply accept the Vector analysis at face value is made all the more concerning by the fact that the GIC noted:

"We understand Vector was able to meet all requests in the annual round for allocating capacity for the gas year 2010-11, which is an improvement on the previous year." (p.9)

The GIC highlights the immediacy of the apparent problem repeatedly in the SOP, yet it is clear that at least for the 2010-11 gas year there are no capacity issues[1]. Contact understands Vector has also recently considered offering additional interruptible contracts for the North Pipeline, yet the GIC makes no mention of how this might impact on any potential capacity constraint.

The GIC also notes that Vector *"…considers that organic growth (from residential and small commercial end users) on the North Pipeline can be accommodated to 2015…"* (p.9)

[1] Nor does it appear that there any issues prior to mid 2009 when Vector first announced its intention to limit access to capacity on its North Pipeline. The GICs enquiries should extend to identifying what changed in 2009 that caused Vector to announce its intention to limit access to North Pipeline capacity.

Contact believes the GIC must provide additional evidence for why it still believes there is a short-term issue despite these three conclusions to the contrary in the SOP.

In addition, the GIC recognises that:

"Overcoming the North Pipeline capacity constraint can be achieved only through building new infrastructure and/or introducing new demand management practices" (p.2)

The fact that the underlying issue is a physical one, as recognised by this conclusion, has important implications for any short/medium term proposed regulatory interventions. In particular, any proposal should not conflict with the incentives required to ensure that investment occurs to remedy the underlying problem.

Capacity options

The SOP summarises information from recent consultations/workshops around capacity options - what we understand from the GIC's perspective to be a medium-term issue.

The SOP notes the key findings from earlier submissions on the capacity options, in particular that the hybrid option (users can elect for long-term capacity, but will otherwise share available pipeline capacity) rated well in terms of the evaluation. It was also identified as a mechanism with useful attributes by most submitters. The discussion in the SOP then transitions from medium-term capacity options (with general agreement around direction for next steps) to one about the apparent need for a short-term intervention in the market. From the statement on p.6 of the SOP, this 'need' appears to have occurred primarily as a result of concerns expressed by Greymouth Gas, who "preferred a short term regulation solution to resolve the competition issue". It is not clear why the GIC chose to favour this option, in response to submissions sought from the broader industry on a medium-term issue.

The GIC does note in the SOP that:

"We expect the outcome of our medium-term work on Vector's access arrangements to resolve the competition issue. However, effective competition is essential for an efficient gas market and in this paper we propose a low-cost solution to this problem, which can be implemented in a short time" (p.7)

Given this statement, and the expectation that the capacity options workstream will resolve its concerns around retail competition, we would expect that any short-term solution would need to have a very clear net benefit and be aligned with likely medium-term solutions, in order to justify the intervention.

Description of retail competition problem

Throughout the SOP the GIC refers to a 'competition issue' or 'competition problem' that it is seeking to address through a short-term regulatory intervention.

Contact is concerned that the GIC has chosen to identify its concerns in relation to the North Pipeline as caused by a 'competition issue', and believes that such a categorisation implies actions and behaviours are occurring in the market that are not supported by the SOP.

'Evidence' of a competition problem

At a high level, Contact is unclear how such an issue could be considered to exist given that, as the GIC notes, all capacity requests for the 2010-11 gas year have been met.

Contact submits that the process and expertise used by the GIC in identifying a 'competition issue' should be made available to participants; especially given the specialist nature of competition analysis and the consequences of behaviours and actions that may contravene competition law, so that they can be assessed and appropriate consideration be given to them.

The details of any competition related complaints have themselves not been made available to participants in order that they may be understood and resolved (if possible) without any requirement for regulatory intervention. Without these details being made available, it is almost impossible to assess the magnitude of any issue, for example is there 1 complaint, 10 complaints? What steps have any complainants or gas customers taken to try to resolve them to date?

If it was formally determined that participants had been engaging in activities and/or exhibiting behaviours that may contravene competition law it is unclear as to why these issues have not been previously raised through available and appropriate channels. The SOP states that the GIC has discussed the preparation of the paper with the Commerce Commission:

"As this matter concerns competition issues, Gas Industry Co has informed the Commerce Commission of the development of this paper" (p.7).

However, no explanation of what the Commerce Commission said to the GIC about the matter is provided in the SOP. The GIC must provide details of communications on this issue to all participants in order that the nature of the concerns being raised can be appropriately considered and understood. For example, as a result of the discussion, did the Commerce Commission agree with the GIC that a competition issue exists and needs to be addressed through short term regulatory measures?

Section 2.5 of the SOP also states that the GIC has its own mandate to examine competition issues under section 43ZN of the Gas Act. Section 43ZN of the Gas Act sets out a list of objectives for the GIC in recommending regulations; all of which must be observed and taken in context. Contact notes that the principal objective is *"to ensure that gas is delivered to existing and new customers in a safe efficient and reliable manner"*.

Contact would be concerned if the 'evidence' provided by the GIC in section 3.3 of the SOP was the total extent of the analysis that led to the identification of a 'competition issue'. The information appears to be informal/anecdotal and lacking in any real detail from which firm conclusions could be derived; as well as the fact it appears to directly conflict with summary statements made around competition in the SOP.

The discussion in the SOP around apparent levels of customer churn ("current competitive activity") appears to indicate a reasonably high level of switching between retailers; particularly when accounting for the relative size of the market. We note though that this doesn't prove or disprove a particular level of competition.

The conclusions drawn from the anecdotal information on tenders for gas supply are also subjective. While the GIC state that *"End users wishing to obtain bids for their gas supply find it is often only the incumbent supplier who can make an unconditional offer."* (p.1) the information provided in the SOP actually shows the opposite; that in both cases the incumbent lost the contract to supply and more retailers than just the incumbent were in a position to make an offer not conditional on securing capacity.

The inferences around the 'cost of reduced competition' are questionable, particularly when considering the myriad of factors that will determine a retailer's willingness to offer gas supply to a customer. The GIC appears to assume that end users will be the beneficiaries of its proposed short-term intervention. However, there is nothing in the proposal that would, for example, prevent the new gas supplier taking up most of the benefit in its offered terms.

Views and behaviour of participants

In section 3.3 of the SOP the GIC makes comments that are wholly unacceptable to Contact. The SOP states that:

"For reasons related to the Commerce Act 1986 (Commerce Act), parties to the VTC may not wish to acknowledge some of those arrangements might be damaging competition". (p.10)

No evidence is produced to support this conclusion and it should be immediately and unreservedly withdrawn by the GIC. A similar comment is made in the *Views and behaviour of participants reinforce Gas Industry's concerns* section (p.13), which should also be withdrawn.

As noted, if there are issues that parties believe may constitute a breach of applicable competition laws then they should be raised and dealt with by the appropriate body.

Economic analysis

The economic analysis provided by the GIC focuses on capacity rents, and the ability of price to ration demand and its balance with supply.

Key to this discussion are concerns raised by the GIC around the lack of secondary trading of capacity; with the inference being that this influences the delivered gas price to consumers, and the ability of retailers to charge 'capacity rents'. The GIC state that:

"…in general, secondary capacity is unavailable to buy" (p.17)

The GIC has not specifically discussed the issue of secondary capacity trading with retailers so we find it difficult to understand how this conclusion can be reached. Contact believes that retailers would generally be prepared to on-sell transmission capacity if the price offered reflected both the cost of that capacity, and the opportunity cost to a retailer of not having that capacity. This is effectively the price rationing role the GIC are seeking.

Contact is therefore surprised that the discussion around secondary capacity trading, and its potential use as a short-term solution to any capacity availability problem appropriately identified, is effectively cut-off in section 4.3 of the SOP. The GIC clearly identifies the benefits of secondary capacity trading: *"secondary trading would reduce or eliminate the diversity-related competitive advantage for major retailers"* (p.17) yet provides no evidence of the level of secondary trading, nor proffers suggestions about how it could be improved. We discuss this issue later on in this response.

Conclusion on problem definition, analysis and evidence

Given that the GIC has identified that the real underlying issue relates to investment in physical capacity, Contact believes that any proposed short term intervention would need to meet a high threshold in terms of problem definition. The SOP does not provide an appropriate problem definition, and confuses physical and commercial arrangements with unsubstantiated claims around competition which would be beyond the GICs jurisdiction.

The GIC has taken Vector's information around capacity constraints at face value and has not ensured that the information is up to date, relevant and applicable. In addition, the GIC notes that all capacity requests were met in the 2010-11 gas year. As a result, in terms of physical capacity available, it is not clear what the market failure is that the GIC is attempting to solve.

Because the SOP repeatedly refers to a 'competition issue', Contact expected that the GIC would provide evidence and support for what the 'competition issue' is, and how it has been discussed with the appropriate bodies (e.g. the Commerce Commission). However, the SOP offers no information as to what the Commerce Commission thought was relevant in terms of competition law, and provides only anecdotal information around competitive aspects of switching and tenders for gas supply, which appears to contradict the GIC's conclusions.

The economic analysis and discussions around efficiency impacts are similarly unsupported, and are largely a series of judgemental statements. Contact believes that the GIC's analysis should focus on quantitative assessments of the efficiency impacts of the current arrangements, in order to identify potential improvements - once a problem has been appropriately defined. The Gas Act and the gas GPS are clear in their focus on efficiency.

The SOP also makes statements around the views and behaviour of participants which are wholly unacceptable.

Option selection and 'evaluation'

Non-regulatory options

The GIC notes the requirements under section 43N (1) of the Gas Act that all reasonably practicable options for achieving the objective of the regulation be identified. It is therefore unclear as to why the only non-regulatory solution discussed is a Vector Transmission Code ("VTC") code change.

In relation to the VTC change option, Contact would have expected that participants with concerns around the effect of rights relating to capacity arising from the VTC would have raised a VTC code change request by now. We understand that any party to the VTC can propose a change. Presumably, if parties to the VTC (not just retailers) perceived there to be a problem, they would raise a change request. We are not aware of such a change request having been made.

As well as the VTC change request option, the GIC should have, and is required to, consider other non-regulatory options. Contact submits that these include:

- Changes via the release of a new, amended VTC in 2011 (delayed from 2010);
- Promotion of a secondary market for trading of capacity (e.g. a simple bulletin board);
- Bilateral trading between shippers; and
- Customer requirements/pressure on shippers e.g. by customers requiring, in supply contracts, that its shipper transfer reserved capacity to any new shipper subsequently appointed by the customer.

These are all reasonably practicable options for achieving the objective. The GIC cannot proceed without considering reasonably practicable options such as these.

Regulatory options

The GIC proposes a number of regulatory options in the SOP.

In terms of the three options grouped under the 'Firm capacity options' heading, Contact is very concerned that the GIC is even considering options which *"limit the growth of physical demand by administrative rules or price signals"* (p.39). Contact expects that such options would potentially breach a number of the objectives of the Gas Act, and it is difficult to see how options which restrict demand could be in the best interests of consumers. We submit that attempting to resolve a perceived competition issue by way of a solution that itself may adversely impact on competition in the gas markets is not tenable.

The interruptible capacity options are similarly concerning and are unlikely to be pragmatic. Contact is aware that Vector has already commenced offering a number of interruptible capacity contracts; we would expect that this would have been accounted for in the GIC's assessment of the problem definition.

It would also be useful for the GIC to discuss options that impact on power station capacity with owners of the relevant power stations, so that the impacts of those options are properly understood.

The demand tariff option appears to be a material change as compared to the existing arrangements, which would be difficult to promote given the issues around problem definition.

Evaluation and cost benefit analysis

The evaluation of the options is of limited value because of the exclusion of the non-regulatory options noted above, as well as the lack of quantitative support for the relative merits of various options. Contact would have expected that the evaluation of all options would be guided by a robust cost benefit analysis, as is required of the GIC.

As it stands, the evaluation is essentially a subjective assessment, and quite different conclusions could be reached depending on how the evaluator judgementally chose to rank various criteria. For example, the SOP notes that 'existing contractual rights' is considered least important of all the evaluation criteria, yet notes that:

"…a major change to existing contractual rights is to be avoided. It can create uncertainty about the integrity of other rights and diminish incentives to invest" (p.33)

As a result of the subjective assessment, these risks are afforded a low priority, despite their clear material impacts; impacts which are likely to be in breach of the objectives of the Gas Act with regard to incentives to invest in transmission.

Again, given that the GIC is submitting a proposal for short-term regulatory intervention, Contact expects that the threshold in terms of analytical support for such a change would be high. The option selection and evaluation is not sufficient to support any regulatory intervention.

The same concerns are applicable in terms of the costs and benefits of the preferred option.

Rather than being a robust assessment of the efficiency impacts (both costs and benefits) of the preferred option, the analysis provided is basically a list of operational costs of implementing that option. The GIC has pointed to likely costs earlier in the SOP (including those detrimental effects resulting from expropriating property rights) so Contact is unclear as to why such impacts have subsequently been ignored[2]. The GIC also fails to attempt to identify benefits or efficiency gains, and seems to indicate that it may not do so at all:

"We therefore consider it unnecessary to numerically evaluate the efficiency gains in this instance" but *" will consider how best to obtain confidential price information to allow it to perform such an analysis should that be required for future work"*(p.48)

It is Contact's view that the GIC is required to conduct quantitative cost benefit analysis to support any proposed regulatory intervention. Comments such as *"it is clear that increased competition will lead to efficiency gains"* (p.48) must be substantiated to be of any value.

The GIC proposal

The issues around problem definition and the lack of quantitative support for the preferred option make comment on the merits of the specific option difficult.

Property rights

Contact is concerned about the damage to property rights that would occur if the proposal is adopted. The GIC notes that:

"…the proposed option will have some material effect on the rights and interests of individuals" (p.25) and that the proposal could *"diminish or remove this value"* (p.33)

The proposal could simply result in a wealth transfer from parties who have legitimately secured transmission capacity to those that haven't, with no evidence of any net efficiency gains from doing so.

This would have serious consequences for regulatory certainty for Vector and other participants; consequences which contradict the objectives of the Gas Act. For example, the regulatory expropriation of capacity rights is likely to make participants more hesitant to invest and grow the market[3], with the risk that the GIC could simply intervene again without substantiation. The Gas Act specifically requires that *"incentives for investment in gas processing facilities, transmission, distribution are maintained or enhanced".*

[2] In addition in section 10.5 of the SOP, the GIC refers to an establishment fee and on-going compliance costs. It is unclear whether these are included in the costs identified in section 9.5 of the SOP.

[3] As acknowledged by the GIC (p.33): "A major change to existing contractual rights…..can create uncertainty about the integrity of other rights and diminish incentives to invest".

Given the long-term physical capacity issue that the GIC has acknowledged underpins its concerns around capacity in the short term, it is concerning that regulatory intervention would be promoted that is likely to dissuade Vector from investing in that physical capacity and detract from medium term options already canvassed, and for which there was some industry support. The intervention could also lower the appetite of customers to contract long term (and encourage 'free riders'); contracts which may be needed to support new investment in capacity. The GICs own regulatory objective requires that *"the solution should not compromise achieving the Gas Act and GPS objectives in the longer term"* but there is real risk it may do exactly that.[4]

Implementation of the proposal

There are also risks in terms of how the proposal would be implemented in practice.

The SOP does not clearly state how it will be determined that a pipeline is constrained, or indeed who would make that judgment. The SOP also lacks any analysis of other transmission pipelines; to which the GIC notes the proposal is intended to apply.

The reality of how tenders for gas supply are run needs to also be discussed in some detail by the GIC. The proposal seems to assume that tenders are typically managed by brokers, and may not appropriately account for the way offers are sought by larger industrial users for example.

The proposed timing of the proposal also raises questions about just how short-term this proposal for regulatory intervention is. It is likely that non-regulatory solutions (if required) could be implemented sooner than the proposal.

The various ways in which retailers have determined the appropriate amount of capacity to secure for a particular user will also create difficulties in determining an appropriate 'Capacity Amount'. For example, a larger retailer may buy a different quantity of capacity relating (notionally or explicitly) to a particular customer than another retailer; particularly if a retailer manages a portfolio of capacity in order to minimise capacity reservation costs.

[4] As noted by the GIC (p.30), the long term objectives could be compromised including "by creating new transition problems for the medium term solution" and "by encouraging Vector, shipper/retailer, or end user behaviour inconsistent with the medium-term objectives".

Next steps

The GICs proposed next steps do not provide an opportunity for submitters to see how their concerns raised in this process will be addressed, prior to a proposal being made to the Minister.

Contact wishes to work with the GIC to address its concerns, but believes that the issues with the SOP are of sufficient materiality that it should not be provided to the Minister in its current state.

Unless the issues noted above can be resolved, we submit that focus on, and resolution of, the medium and longer term issues (i.e. capacity options and the creation of an environment conducive to investment in capacity) will create significantly more value than could be achieved through this short-term work stream.

Specific answers to Questions

Question	Contact Energy response
Q1 Do you agree with our description of the retail competition problem?	No
Q2 Do you agree with the economic analysis?	No
Q3 Do you agree with the proposed regulatory objective?	The regulatory objective is not appropriate due to the issues around the problem definition
Q4 Do you consider that the evaluation criteria are appropriate for evaluating the options?	The criteria and their application are subjective and the outcomes of the evaluation could be quite different depending on how the evaluator chooses to rank them
Q5 Do you have any comments on the evaluation of options?	The evaluation is not sufficient to substantiate the proposal and lacks quantitative support
Q6 Do you agree that Gas Industry Co has, through the evaluation of options, correctly identified the 'Capacity Follows End User' as the preferred option?	Because the criteria and their influence are entirely subjective, the outcomes of the evaluation could be quite different depending on how the evaluator chooses to rank them
Q7 Do you have any comments on the details of the proposal?	See body of submission
Q8 Do you agree with the next steps?	No