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30 August 2013

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Gas Industry Company Limited
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Dear Steve,

Please regard this letter as our submission on the report on "Gas Transmission Investment Programme, Status and Development – July 2013", and the accompanying report with "Advice from Panel of Expert Advisers". We have reviewed both of these reports and benefited from the industry workshop held on 12 August 2013 to discuss them.

Our submission starts with the main points we would like to make. We will then provide our detailed responses to the specific questions that the GIC has asked. We will close with remaining comments that cropped up during our review. In this letter we will use the terms "MDL", "we", "us" and "our" to refer to the Gas Transmission Business of Maui Development Limited. Please note that views expressed in this submission may not necessarily represent the views of the individual shareholders of MDL.

Main Points

- Transmission capacity and access are not currently a concern on the Maui Pipeline. Based on the results from the supply and demand outlook project we expect that the Maui Pipeline will have a sufficient supply of capacity to meet demand in all scenarios[1].
- It is now also clear that capacity concerns on Vector's North Pipeline arose from contractual congestion; not physical congestion.
- The contractual arrangements of the Maui Pipeline Operating Code (MPOC) are such that contractual congestion on the Maui Pipeline is avoided. The MPOC allows and facilitates full utilisation of all available Maui Pipeline capacity on each day.
- The GTIP priority should now be refocused on Regulatory Projects. While short-term capacity risks do not exist, appropriate incentives which allow recovery of the cost of prudent investment in maintenance, reliability or capacity are currently not evident.
- We recommend that the GTIP place greater emphasis on the design of an investment test for gas transmission pipelines. This must include investments needed to maintain and protect existing transmission capacity, to ensure transmission is a viable commercial activity for investment.
- Most of the issues in the new problem definition proposed by the PEA do not seem to apply to MDL.

[1] Even in a low gas price scenario, demand on the Maui Pipeline is not expected to reach levels that could give any cause for concern until 2019.

- We currently see that common governance is unlikely, and would be contingent upon radically different business arrangements on the two pipelines. We agree it would be efficient for the MPOC and the Vector Transmission Code (VTC) to have matching requirements for topics such as technical standards, metering, gas quality assurance, and dispute resolution. We also point out that Schedule 9 of the MPOC already sets out principles for obtaining compatibility. As an example for implementing those principles, we would be open to see progress in relation to enhancing incentives for daily balancing.
- For the reasons we set out in more detail below, we have reservations as to the applicability to MDL of most of the "indicators of success" and recommendations proposed by the PEA.

Responses to Questions

Q1 Do you agree with our assessment of the GTIP thus far? If not, where does your assessment differ from ours?

Our comments on the assessment of the GTIP projects, other than the Regulatory Projects, are set out below.

Vector's Capacity Determination Project

We agree this is complete. However, we believe it is important to emphasize that Vector's published capacity numbers represent estimates of ex-ante capacity based on worst-case (1 in 20 years) scenario assumptions. Capacity is not a static number, but depends on actual flows at each welded point on the pipeline. Therefore, the actually available capacities on a day can be significantly higher than capacities that were conservatively estimated ex-ante.

Supply and Demand Outlook Project

We appreciate this was done. We note that the Maui Pipeline is expected to have sufficient capacity under all scenarios presented in the resulting report[2] from Concept Consulting. Therefore, there should be no regulatory concern about capacity on the Maui Pipeline.

Transmission Market Disclosures Project

We note this project is still in progress. Subject to protection of Confidential Information, as it is defined in the MPOC, we are in support of a high degree of transparency on pipeline information.

Backstop Information Gathering Project

We agree this project is completed.

Transmission Access and Capacity Project

- This project was originally intended for arrangements on the Vector pipeline. Indeed the entire GTIP was launched due to concerns over capacity in Vector's North Pipeline.
- We do not believe there needs to be any concern over access and capacity on the Maui Pipeline. The Maui Pipeline is expected to have sufficient capacity in the foreseeable future, and the MPOC arrangements already allow maximum daily allocation and utilisation of that capacity.

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[2] We suggest that timing of updates to the Supply and Demand Outlook be optimised to inform the preparation of Default Price-quality Path determinations by the Commerce Commission.

- We do agree that the pricing of our capacity prioritisation mechanism in the form of AQ[3] needs to be reconsidered. However, we expect to do so as part of a Customised Price-quality Path (CPP) application that we intend to submit under Part 4 of the Commerce Act. Such an application will include a review of our pricing methodology, and will require public consultation.

Gas Trading Arrangements Project

We agree there is little justification at present for pursuing this project, and that it can be left suspended.

Q2 Are there any Projects you think should be given greater or lesser attention by Gas Industry Co? Are there any other projects you think should be considered as part of GTIP?

We recommend that GIC should shift its priority to the Regulatory Projects. We believe it is important to now start working on those. Our reasons and concerns are as follows.

- There is little need for short-term investment in new capacity. The original concerns that led to the GTIP arose from contractual congestion; not physical congestion.
- However, it is also important to facilitate investment to maintain existing capacity.
- The Commerce Commission determinations for the Part 4 regulation of gas transmission businesses have been completed. These determinations do not include an investment test or provide for capital expenditure that is more than 20% above historical average. This effectively rules out any significant gas transmission investment under a Default Price-quality Path (DPP). This means appropriate incentives for gas transmission investments are not in place.
- We believe it should now become a priority for the GIC to consider a Regulatory Investment Test[4] that can help to facilitate investments.

Q3 Do you agree that the characteristics of a well-functioning transmission market, as described by the PEA, could be used as criteria for evaluating regulatory options?

No. The criteria proposed by the PEA may be regarded as interesting but in our view they are not definitive. If the GIC wishes to recommend regulations then it needs to do so under the terms of the Gas Act 1992. This includes assessment against the objectives in section 43ZN of that Act.

We should also point out that we do not believe MDL or the Maui Pipeline operating regime is contravening any objectives of the Gas Act.

Q4 Do you agree with the proposed way forward for the Information Projects?

In respect of the Maui Pipeline we are already providing all necessary and sufficient information for technical understanding.

We believe that having accessible information on gas flows for each large meter elsewhere on the transmission system as well will greatly assist the sound discussion of industry issues.

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[3] Meaning an Authorised Quantity as defined in the MPOC.

[4] Such as described by Vector in their submission of 7 June 2011 on the proposed GTIP, referenced at http://gasindustry.co.nz/sites/default/files/u254/vector_submission_on_gtip.pdf

Q5 Do you agree with the proposed way forward for the Market Projects?

We see that, with minor changes to the MPOC, MDL can already achieve most of the objectives sought. For example, revising the pricing basis of AQ, and facilitating trading of AQ with disclosure of AQ traded prices, will provide price signals for users concerned about capacity, at the same time as providing the ability for users to manage curtailment risk.

Q6 Do you agree with the proposed way forward for the Regulatory Projects?

For the reasons we indicated in our response to Q2, we propose that a regulatory investment test should indeed be developed with a high priority. Not only for evaluations of investments in new capacity, but also for investments to protect, support and maintain existing capacity.

Q7 Do you agree with the Problem Definition? If not, please explain your reasons.

No. The restated problem definition does not distinguish adequately between Maui and Vector pipeline issues. Our views and comments on each of the problems included in the PEA's definition are set out below.

problems defined by PEA	MDL views and comments
Efficient allocation of scarce capacity, both physical and commercial (i.e. as defined by contracts/codes)	Allocation of capacity on the Maui Pipeline is highly efficient already. We do agree that pricing of capacity may need to be reviewed, but in the absence of a supply constraint this has historically not been a problem for MDL.
Price signals to facilitate efficient investment	Agree in principle, but current price control regulations may prevent such price signals being useful for efficient investment.
Transparency on physical state of the pipelines and contractual arrangements for use of the pipelines	Not a problem on the Maui Pipeline. (Assuming "physical state" means gas delivery performance relative to capacity.)
Grandfathering of capacity may reduce competition to supply downstream users	Not a problem on the Maui Pipeline[5], at least not to the extent that any fix is warranted at this stage.
Unnecessary costs may arise from different Maui and Vector access arrangements	Perhaps, but any such costs must be set against the costs of change.
End users do not secure long term capacity rights on the Maui pipeline	Users could apply[6] for an AQ if they were concerned about a long term capacity right. Due to the efficiency of utilisation of capacity on the Maui Pipeline, users have been satisfied with current arrangements.

[5] Note that capacity curtailments on the Maui Pipeline, when necessary, are made on the basis of historical usage in the previous 12-month period. However, this is a sliding window. Unless all of the daily capacity on the Maui Pipeline would be fully used for a long and consistent period, we do not believe this could be an anti-competitive issue.

[6] End users could obtain an AQ by becoming a Shipper under the MPOC themselves, which is easy to do, or by making suitable arrangements with another Shipper.

Vertical integration demands special care that arrangements cannot favour affiliate businesses	Not a problem on the Maui Pipeline[7].

Q8 Do you agree with the assessment of the current state of the market for transmission capacity? If not, please explain your reasons.

No, we believe the concerns about transmission capacity limits are exaggerated. As we set out in our submission on 24 August 2012 to the first PEA report, problems on the Vector line are caused by contractual congestion; not physical congestion. The Vector regime leads to under-utilisation and artificial scarcity for two main reasons.

- First, the ex-ante allocations must be made on conservative estimates of pipeline capacity that is expected to be available in all circumstances. This means that the capacity allocated by Vector is less than the capacity that is actually available on most days of the year.
- Second, Vector's regime of overrun charges incentivizes their shippers to overestimate or overbook capacity in comparison to what they may actually need. Shippers will tend to book capacity on the basis of their highest case needs, instead of average needs.

This leads to a double whammy. Vector will structurally under-estimate capacity that is available. Shippers will structurally over-estimate and overbook capacity that they need[8].

After suffering these constraints in ex-ante allocation, Vector shippers are faced with further constraints in on-the-day allocation of capacity on the Vector system.

- First (or third), in the absence of a nominations regime, any initially allocated but unutilised ex-ante capacity cannot be used by any other shipper on the day unless the first shipper explicitly makes it available for trade.
- Second (or fourth), such trades, even when offered, are hampered by the point-to-point allocation of Vector capacity, which often makes it impossible to reallocate pipeline capacity for use at another point, even if there is no physical reason to restrict such a reallocation.

This double double whammy (or quadruple whammy) leads to underutilisation of physical capacity that Vector may actually have available.

These problems do not arise on the Maui Pipeline. Even when pipeline utilisation is high the MPOC regime allows full utilisation of all physical capacity that is available on each day. This means that premature contractual congestion should not arise on the Maui Pipeline.

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[7] MDL is owned by the Maui Mining Companies. Ring-fencing provisions in the MPOC require management of the Maui Pipeline to be kept at arm's length and separate from MDL's non-pipeline businesses, and operational functions to be contracted to independent operators.

[8] This would not be a problem and Vector's current regime can be efficient and effective in situations where the supply of capacity is significantly higher than demand. However, it obviously becomes a problem when inflated demand starts reaching deflated supply.

Q9 Do you consider that the PEA has considered all the reasonable options for improvement? If not, what other options would you wish to have considered?

We do not have suggestions for other options in addition to those presented in Chapter 5 of the PEA report.

Q10 Do you agree that Evolutionary Convergence is the best approach to improving access arrangements? If not, what other option do you prefer?

We broadly agree that Evolutionary Convergence is the most appropriate option to pursue provided that such evolution is in accord with good international practice. In particular, we support progressive changes to current arrangements (instead of any "big bang" approach) in order to:

- allocate capacity rights based on willingness to pay when scarcity arises; and
- generate and publish price signals about the value of capacity rights.

Instead of inventing different solutions to these problems for MDL and for Vector, we agree it would be desirable to collaborate in finding solutions that are at least compatible with each other.

Our support, however, is subject to the caveats in the rest of our submission. In particular, we are concerned about any impression that convergence would be an objective by itself.

Q11 The PEA proposes a set of 'guiding principles'. Do you agree with these principles? If not, what alternatives would you propose?

The "guiding principles" form the heart of the PEA report. In general, we have a concern that some of those principles go well beyond the scope of issues that led to the GTIP. Our detailed comments on each of the proposed "guiding principles" are set out below.

Offer mix of harmonised transmission services across both systems

- We support a mix of transmission services that are compatible across both systems. However, we do not consider it necessary for services on both systems to be identical or unified.
- A key point in determining capacity is to distinguish between the conservative estimates required for ex-ante longer-term allocations and dynamic determinations, based on current and actual pipeline conditions, that can be used for on-the-day allocations. The actually available capacity on a day will almost always be higher than the conservative ex-ante estimate.
- The MPOC currently allows MDL to make up to a maximum of 70% of its capacity (estimated ex-ante) available for AQ[9]. In the absence of any other criteria this seems like a reasonable proportion to make available as (quasi-)firm longer-term capacity on the Maui Pipeline[10]. If other criteria are developed then the MPOC can be amended to adjust this proportion.

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[9] Due to lack of demand for firm capacity on the Maui Pipeline, the actually allocated proportion is zero.

[10] We believe it is desirable to leave short-term capacity available too.

- A key feature of a nominations regime is that it not only facilitates curtailment on a day, but also (prior to any curtailment) allows full allocation of all capacity that is actually available on a day, including:
    - capacity that exceeds the conservative estimates used for ex-ante determinations; and
    - unutilised capacity (i.e. capacity for which there is no on-the-day nomination) of Shippers with long-term firm capacity allocations[11]. (This prevents hoarding.)
- We do not agree that curtailment on the basis of usage in the preceding 12 months confers an in-perpetuity preference.

'Bolt on' arrangements for capacity pricing when scarcity occurs

We generally agree with this principle and the accompanying explanation in the PEA Report. We should point out, however, that the most obvious secondary allocation process is a nomination system. The process with nominations by Shippers being approved by the pipeline operator provides and allows a close to real time capacity allocation[12], based on the best available information at the time.

We also note that the MPOC allows Shippers to trade AQ with each other. This effectively allows a secondary market for longer-term allocations of capacity priority rights, which can provide price signals if capacity becomes scarce[13]. This is an arrangement that has already been "bolted on".

Improve transparency of information

We generally agree with this principle, noting that MDL already provides a high degree of transparency.

- The MPOC already requires MDL to post a Rolling Capacity Forecast at all times, based on aggregates of individual Shipper Rolling Forecasts, for the next 12 months.
- In light of the overall revenue cap imposed on Gas Transmission Businesses under Part 4 of the Commerce Act we do not believe it is particularly helpful to design separate cost recovery arrangements for providing information.
- We agree that suggestions to externalise information provision functions are not a priority.

Governance for pipeline capacity access and pricing

We mostly disagree with the suggestions made under the heading of this principle.

- We support increased compatibility, but are concerned about misinterpretation of an objective towards harmonisation. We do not share an objective to achieve unification with the Vector regime except with fundamental changes to the underlying business arrangements.
- We do not agree with suggestions regarding a common governance arrangement for Maui and Vector pipelines.

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[11] Assuming that shippers with firm capacity are required to make nominations too.

[12] And in the absence of demand for long-term capacity on the Maui Pipeline this is, in fact, the only allocation mechanism used by MDL at present.

[13] We should note, however, that Maui Pipeline capacity in the AQ Zone South of Mokau is never expected to become scarce.

- We agree it would be useful and convenient for the MPOC and the VTC to avoid unnecessary differences. For example, we would support harmonised arrangements and matching requirements for topics such as technical standards, metering, gas quality assurance, and dispute resolution. Additionally, we would welcome Vector applying greater incentives for primary balancing within its system.
- We expect MPOC and VTC code changes can be coordinated as necessary or convenient, but do not agree that there is a need for a common code development process.
- We agree that the change provisions in section 29 of the MPOC allow evolution of the Maui operating regime to reflect future needs.

Q12 Do you agree with the PEA's overall conclusion, including its 'indicators of success'?

Our detailed comments have been set out above. Broadly speaking, we support the overall characteristics of a well-functioning market proposed by the PEA. In particular:

- we agree that a compatible (not necessarily identical) menu of transmission services across both pipeline systems would be a positive development;
- we agree that scarce capacity should be allocated based on willingness to pay where it is possible and practical to do so[14];
- we agree that existing transparency on the Maui system provides a good foundation.

We do not agree with the "indicators of success" proposed by the PEA. These proposed indicators, and our views and comments on them, are set out below.

1. A memorandum of understanding has been agreed between Maui and Vector to develop and implement governance change processes and provide for the development of an implementation plan.

   We are happy to consider arrangements for working together with Vector in areas of mutual interest, but do not see it as an indicator of success.

2. Change requests to implement governance have been formulated and proposed by November 2013.

   To the extent that "governance" means governance over any aspect of the Maui transmission regime, we see no possibility of shared or evolving arrangements.

3. Governance arrangements are in place to facilitate implementation of operational changes in a timely way.

   MDL already has suitable governance arrangements in place.

4. There is sufficient information transparency for industry and wider stakeholders to be confident that they can assess the likelihood of congestion on pipeline systems (Maui and Vector).

   MDL already provides sufficient transparency.

5. There is confidence in the industry that any short term excess demand for capacity can be managed in a way that ensures that scarce capacity is allocated to the highest value uses.

[14] We expect that development of Queuing Rules and pricing for AQ can be managed to meet this goal for the Maui Pipeline.

We believe that industry can have confidence that MDL will support any initiative for transparent trading of AQ priority rights. We consider that such trading can ensure that if capacity is scarce then the AQ rights will be allocated to the highest value uses.

Maui Pipeline curtailments on a day are initially allocated to Shippers on the basis of their historical usage in the preceding 12 month period. This may be considered as a proxy for value. We are willing to amend curtailment priorities on the basis of more specifically value-based indicators. This would need to be designed and would require changes to the MPOC. We would be willing to support such changes, but we are not aware of any urgent demand from industry to pursue them.

6. Planning for a mechanism to enable price signals for scarcity on a longer term timeframe is in place, and will be implemented in accordance with cost benefit criteria.

We believe that such a mechanism can readily be established on the Maui pipeline by the transparent trading of AQ priority rights.

In addition, we expect to explore this further as part of our intended CPP application, which will be subject to consultation. A starting point for MDL will be to review its pricing methodology to apply to the initial release of AQ priority rights. Any changes to the MPOC resulting from a change in pricing methodology will be subject to industry consultation and GIC review.

7. GIC is able to provide assurance to the government that any future shortage of capacity will be able to be handled in an efficient way.

We believe MDL already manages its capacity in an efficient way. We expect to implement appropriate AQ arrangements if demand for them arises. Capacity shortages on the Maui Pipeline have been forecast to be unlikely in the next 15 years.

Q13 Do you agree with the PEA's recommendation to Gas Industry Co?

We mostly agree with the PEA's first recommendation, except for principles relating to common governance. We do not agree with the PEA's other recommendations to the extent that they could apply to MDL.

Q14 Several boxes with dashed borders appear throughout the PEA's Second Advice paper. These boxes contain material that has been discussed by the PEA but not sufficiently closely examined to draw firm conclusions. Do you have any comments on this material?

Given the status of the content in the boxes with dashed borders we have not reviewed these thoroughly. Nevertheless, and at risk of repeating some points made earlier, our preliminary views on each of them are set out below.

Section 6.1.6 box titled 'Possible initial components of a development path'

We believe it is desirable to have services on the Maui and Vector systems that are compatible with each other. We have a concern that "harmonisation" could be interpreted in a way that may be outside the scope of the GTIP and exceeds what is necessary.

We generally agree with the components covered by the bullet points in the box, with the following caveats.

- We expect "firm" priority rights on the Maui Pipeline to be based on AQ provisions in the MPOC. This allows for capacity allocations by zone. We have no intention of adopting a long-term point-to-point capacity system.

- We expect that historical usage in the preceding 12 months could remain a practical and convenient allocation mechanism for on-the-day curtailments[15]. Because that historical usage changes dynamically over time we do not consider it a static "grandfathering" arrangement.

Section 6.2.2 box titled 'Rotowaro model'

We do not believe this approach would be suitable on the Maui Pipeline.

Section 6.2.3 box titled 'Possible initial components of a development path'

These proposed arrangements are unnecessarily complex for the Maui Pipeline and we do not agree with the adoption of the "Rotowaro" model.

Section 6.3.4 box titled 'Possible initial components of a development path'

We generally agree with the content in this box, except for suggestions to establish separate pipeline charges for providing information. In light of the overall revenue cap we have under Part 4 of the Commerce Act, we see little benefit in breaking out our pipeline charges to such a fine degree.

Section 6.4.2 box title 'Possible initial components of a development path'

We will indeed use the change provisions in the MPOC to make any changes to the Maui operating regime. We will not develop a separate rule development process for changes affecting our allocation priority rights and pricing. We have no objection to adoption by Vector of MPOC provisions.

Remaining Comments

During our reviews various other comments cropped up as well. These are covered below.

- Because of the MPOC requirement for 12 month Shipper Rolling Forecasts we should have early warning if there is a possibility of congestion emerging on the Maui Pipeline.
- Allocation of capacity on the Maui Pipeline when it becomes scarce, i.e. in case of curtailment, is governed MPOC provisions and is completely neutral and transparent.
- In light of the overall revenue cap imposed on MDL by the Commerce Commission determinations we can confirm that we are indeed broadly neutral with respect to capacity pricing arrangements.
- However, it will be necessary to have capacity pricing arrangements that actually allow transmission system owners to make investments if capacity were to be come scarce. For example, if congestion rents from capacity can only accrue to shippers then, in the absence of other mechanisms, pipeline owner may never have an incentive to invest under the restrictions of a revenue cap.
- We will be concerned by any cost-benefit analysis in which we incur cost for the benefit of industry without an ability to recover those costs. This is particularly relevant when revenue caps imposed by the Commerce Commission constrain us from recovering additional costs we incur for implementation of any plans. In such circumstances we believe costs to achieve benefits for the industry should be funded by the industry.

[15] Although we are willing to make changes if there is industry demand for different curtailment arrangements.

- The AQ regime in the MPOC represents a priority right to capacity, on a long-term basis. This right is subject to a requirement to nominate quantities for each day. If a shipper's nominations on a day do not use the full volume of its AQ for that day, then the unused volume becomes available for other shippers on that day. This prevents hoarding and allows maximum utilisation of all pipeline capacity on each day.
- We have reservations about recommendations for establishing, "harmonization", and trading of capacity rights. The AQ mechanism was carefully designed as the most appropriate type of long-term capacity right for the Maui Pipeline. Any type of capacity rights which by their legal design may lock out new entrants from capacity, even if that capacity is not used, are not efficient and may lead to (and have led to) issues of contractual congestion. Therefore, we do not support replacing the AQ priority mechanisms of the MPOC with a "firm" capacity rights regime.
- Accordingly, we do not intend to offer a "no notice" service on the Maui Pipeline under which Shippers can book and maintain (and hoard) capacity without being required to nominate for its actual usage.
- We do not expect to have grandfathering rights as part of the Queuing Rules (which are subject to GIC approval) for future allocations of AQ.
- Secondary trading of capacity on the Maui Pipeline, in the form of AQ trades as provided for under the MPOC, would not lead to additional revenue for MDL. The congestion rents from such trades would be captured by the Shippers having an AQ.
- Trades of AQ between Shippers on the Maui Pipeline do not require MDL's consent.
- The box in Table 3 on page 25 of the PEA report that covers "Requirement to make Code change" for Maui/MPOC erroneously uses the word "or" instead of "and". MPOC changes require a positive recommendation from the GIC and MDL's consent in writing.
- We note that the MPOC rule change and enforcement processes do not discriminate in favour of, or against, the interests of any particular participants.

Conclusion

We appreciate that work under the GTIP and by the PEA is helping to clear the fog around gas transmission capacities and allocations. We hope our submission contributes to this goal.

Our main recommendation to the GIC is to refocus the GTIP on gas transmission investment.

We have appreciated the opportunity to provide this submission. For any additional questions or clarifications please do not hesitate to contact us.

Yours sincerely,

Jelle Sjoerdsma
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for Maui Development Limited