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Ian Wilson
Gas Industry Company
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By email: submissions@gasindustry.co.nz

Dear Ian

Genesis Energy believes the GIC has not established a case for intervention

Genesis Power Limited, trading as Genesis Energy, welcomes the opportunity to provide a submission to the Gas Industry Company ("GIC") on the consultation paper "Retail competition and transmission capacity: Statement of proposal" dated November 2010.

Genesis Energy considers that the GIC has not presented a sufficient and compelling case to justify the regulatory intervention proposed. In particular, there are a number of deficiencies in the GIC's proposal from a regulatory and legal point of view:

- the GIC has not looked beyond allegations of poor competition to determine whether a market failure or regulatory failure exists;
- the GIC has not assessed an appropriate range of options; and
- the GIC has not prepared a quantitative cost-benefit analysis (CBA) despite being required to under s43N(1) of the Gas Act ("the Act").

These deficiencies are inter-related in that identifying appropriate options and analysing costs and benefits should properly follow on from correctly identifying and describing the underlying market or regulatory failure. If the GIC does not follow these steps then it risks intervening unnecessarily or inappropriately. The

consequences of this could include: imposing costs that outweigh the benefits; causing unintended consequences; failing to adhere to statutory obligations under the Act; and being seen as a “soft touch” for parties seeking regulatory intervention for commercial advantage.

We agree that it is appropriate for the GIC, given its functions under the Act, to investigate whether reports of difficult trading conditions in the Auckland gas market are symptomatic of a regulatory failure. We do not think there is a clear case that capacity arrangements are a problem. The GIC’s proposed solution may essentially transfer capacity rentals from gas shippers to incumbent large users. Such a wealth transfer is not likely to further the GIC’s statutory objectives, may weaken economically beneficial price signals, may exacerbate potential problems with investment incentives and may worsen the position of potential new gas users.

To the extent that there is a market or regulatory failure, we expect that this is most likely to be related to flaws or gaps in the regulation of monopoly gas transmission services. Potentially, the Commerce Commission’s regulation of gas transmission services under Part 4A of the Commerce Act 1986 may be overly deterring investment in new capacity. Additionally (or alternatively), the collective regulatory regime for gas transmission services may fail to adequately address governance issues. This appears to be the case with respect to balancing arrangements and may similarly be the case here.

If the GIC were able to substantiate the potential failures described above, then its range of options would include intervening to alter capacity arrangements directly (as currently proposed), but would also include options such as intervening to alter transmission code governance arrangements, improving separation between Vector transmission and Vector wholesale, waiting for the Commerce Commission to fully implement its regulatory regime under Part 4A of the Commerce Act 1986 or requiring Vector to invest in additional transmission capacity.¹ Note that we are not advocating any of these interventions at present and would be particularly reluctant to advocate the last option. However, we believe that, once the GIC has developed a better understanding of any underlying market or regulatory failure, these options should be assessed side by side.

To provide some further context for our overall position above, the remainder of this submission provides some observations on issues related to gas transmission pipeline constraints.

¹ As per the power provided under s43F(2d) of the Act

Price Signals and Capacity Rentals

In a rationally functioning market, prices should increase to reflect increasingly scarce goods or services. Price-based rationing should enhance economic welfare by encouraging the efficient allocation of scarce pipeline capacity between incumbent and potential gas users while also signalling to investors the need for additional investment.

Because Vector's transmission arm is a regulated monopoly it cannot increase its capacity charges to reflect increasingly scarce capacity. In practice, long-standing gas shippers may instead be capturing capacity rentals to some extent (although this is not a given). Normally, such rentals would provide some reward for parties that have taken a risk in investing in constructing or maintaining pipelines, or in contracts that support such investment.

To the extent that incumbent shippers are capturing capacity rentals, the GIC's proposal would start to transfer those rentals to large incumbent gas users. This would eliminate the price signal normally associated with scarcity, in this case scarcity of transmission capacity. The effect of this would potentially be to undermine efficient reallocation of pipeline capacity to parties able to produce the greatest economic value from gas consumption. As such, the GIC's proposal may have a detrimental impact on allocative and dynamic efficiency.

Competition rationale

The GIC's strongest justification for its proposed intervention appears to be that it will have a pro-competitive effect on the large user segment of the Auckland retail gas market. Genesis Energy is a strong supporter of pro-competitive market arrangements, however we do not believe that this provides a standalone justification for intervention in this case.

If parties are concerned about competition problems arising from anti-competitive shipper conduct then those parties ought to pursue relief under the Commerce Act. As we discussed above, the risk we see is that by over-ruling existing contractual arrangements in the absence of a solid justification for intervention, the GIC may come to be seen as a "soft-touch" by parties seeking individual competitive advantages. Moreover, the long-term effects on the investment climate through the unjustified intervention in legitimate property rights and contracts are unknown but potentially significant.

Setting aside market conduct issues, the GIC intervening to transfer rentals to consumers might be a legitimate option provided it does so in response to a market or regulatory failure and it is careful not to give short-term gains to consumers, or a subset of consumers, at the expense of overall long-term

economic welfare. We note that the Gas Act does not provide a basis for favouring wealth transfers to consumers over economic efficiency. Competition is one of the GIC's secondary objectives under s43ZN of the Act where it is only framed in terms of minimising barriers to competition. Genesis Energy believes that the proposal risks conflicting with the GIC's principal objective under the Act, particularly with respect to allocative and dynamic efficiency and also because it may worsen new customers' ability to access gas.

We therefore recommend that the GIC does not continue to pursue its preferred option and instead considers whether there is a case to intervene at the transmission code governance level.

If you would like to discuss any of these matters further, please contact me on 04 495 6357.

Yours sincerely,

A handwritten signature in black ink that reads "John Bright". The signature is written in a cursive style with a small vertical line to the left of the name.

John Bright
Regulatory Affairs Analyst