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SUBMISSION ON DRAFT RECOMMENDATION ON 10 OCTOBER 2014 'MARKET-BASED BALANCING' MPOC CHANGE REQUEST

1 Introduction

1 MDL welcomes the opportunity to submit on the Draft Recommendation on the 10 October 2014 'market-based balancing' MPOC Change Request (**mbb CR**). In this submission we will use the terms "MDL", "we", "us" and "our" to refer to the Gas Transmission Business of Maui Development Limited. This submission has been prepared by the Commercial Operator for and on behalf of MDL and does not necessarily represent the respective views of MDL's shareholders.

2 MDL agrees with Gas Industry Company (**GIC**) that the amendments proposed in the mbb CR (**Amendments**) align with the objectives of section 43ZN of the Gas Act 1992 (**Act**).

3 Given we generally agree with GIC's reasoning and conclusions, we focus in this submission on matters – related to both GIC's and Covec's analysis – which would benefit from further clarity. We have attempted to capture what we see as the salient points as briefly as possible; and, per GIC's request, to avoid unnecessarily repeating our earlier submissions.

2 High level remarks

4 MDL agrees with the GIC that:

- balancing remains a problem;[1]
- Line Pack flexibility has a (value and) cost, which should be signalled to pipeline users;
- users respond to incentives;
- the adjustment creates an appropriate and effective primary balancing incentive;
- information shortcomings are not as significant as some submitters make out;
- the availability of better tools and information is not a pre-requisite to the introduction of a daily cash-out regime;[2]
- there is nothing in the mbb CR that requires further investment; the development of better tools and information will only occur where users determine it is commercially worthwhile (and when it does, it will improve market efficiency);
- the Amendments will improve price signals, which in turn will:
    - sharpen investment incentives and enhance investment decisions;
    - improve the functioning of the flexibility market;

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[1] We note that GIC agrees with MDL's summary of *why* balancing remains a problem (refer section 5.8 on page 64). We also support GIC's acknowledgment that the oft-referred to graph showing declining balancing gas volumes – included in the Draft Recommendation as Figure 10 – "does not tell the full story."

[2] We agree with GIC's remark that, "until price signals are available on the value of improving primary balancing (rather than being cashed-out) it would be difficult to assess the economics of investing in more frequent nominations cycles and more timely reconciliation" (section 5.2, page 60).

  - improve the targeting of costs to causers, and therefore allocative efficiency;
  - improve primary balancing, reducing security of supply risks and encouraging them to be more efficiently managed; and
- the Amendments will remove barriers to competition in the balancing market, creating downward pressure on prices.

5 We also agree with Covec that:

- current primary balancing incentives are weak;
- implementation of the Amendments would improve primary balancing;
- claims made about users' lack of ability to respond to incentives are not borne out by the data;
- the impact of the Amendments will not be uniform across all pipeline users;
- cash-out related cash flows should be excluded from the analysis;
- any shipper investment in extra administrative effort to better manage their positions should also be excluded from the analysis;
- it is appropriate to value resources at market rates; and
- the annual benefits are likely to change over time.

6 MDL has taken further independent advice from NERA, and in Chapter 3 below we offer some specific thoughts on Covec's analysis. The main point we would like to make is that, while the quantitative element of the report reveals a clear and stable net benefit in the order of a million dollars – which is compelling of itself – we expect unquantified benefits to dwarf this figure by a multiple factor, particularly when viewed from a dynamic efficiency perspective. This appears to have been tacitly acknowledged in Covec's report, in the Draft Recommendation[3] and in both GIC's and Covec's presentations at the 10 and 11 March workshops, however we think the point should be given more emphasis in the final analysis.

3 Costs and benefits

7 If the mbb CR is implemented, the costs users pay for balancing the Maui Pipeline will reduce; there will also be significant efficiency gains, increasingly so over time. Covec quantifies some costs and benefits, concluding that there is a sufficiently large expected net benefit across a range of scenarios for it to be unnecessary to quantify other identified benefits. We agree the quantified benefits are compelling; however, as noted in paragraph 6 above, we question whether the report underplays the significance of the unquantified benefits.

3.1 Allocative and dynamic efficiency

8 Both GIC and Covec recognise that the Amendments would create various efficiency gains.[4] We think more weight could be given, however, to expected allocative efficiency gains, which we see as central to an economic assessment of the mbb CR. In our view, two key allocative efficiency gains would manifest:

[3] See for example GIC's view that "At this stage we are not convinced that [obtaining a rigorous assessment of claimed upstream benefits] will be necessary and note that Covec's Cost-Benefit analysis also does not quantify these claimed benefits." Draft Recommendation, section 5.5, page 61

[4] For example, in its conclusion on page 3 Covec recognises "dynamic efficiency gains from better price signals and increased market liquidity".

- an improved price signal to users of the cost of Line Pack flexibility, resulting in more efficient use of and more broadly increased competition between flexibility mechanisms; and
- a reduction in cross-subsidisation, resulting in more efficient use of Line Pack flexibility.

3.1.1 *Improved price signals*

9 The lack of a price signal on inter-day Line Pack flexibility is the core problem with the status quo, as Covec notes. In a static sense this is allocatively inefficient, but it also leads to dynamic efficiency issues – e.g., skewed incentives to invest in other forms of flexibility. GIC unambiguously recognises this, and the fact that the Amendments would improve the situation.[5] However there is no attempt to quantify the expected benefit (as Covec itself acknowledges). Instead the focus is on what might be called the lower hanging fruit: net Balancing Gas and balancing-related Fuel Gas costs. Reductions in both these costs are certainly benefits; however, we submit that greater weight should be given to the unquantified efficiencies that would follow from clearer price signals.[6]

3.1.2 *Reduced cross-subsidisation*

10 We agree with GIC that, "[i]f the MBBCR was implemented…users who may previously have been able to use the ILON process as a source of cheap flexibility (at the expense of others), would no longer be able to do so."[7] The Amendments in reducing cross-subsidisation would create a more efficient distribution of balancing charges, ensuring that, for a given user, the charges it receives better reflect the cost of service to that user.[8]

11 Recognition of this benefit appears to be missing from Covec's report, which (on page 1) effectively 'throws the baby out with the bath water' in excluding from the analysis "the financial flows that would occur as a consequence of daily cash-outs." That is to say, it rightly discounts cash-out related cash flows from the cost-benefit analysis (the bath water), but, in our view, wrongly disregards the benefits that will follow from creating a more efficient distribution of cash-out charges (the baby).[9]

12 There should be quite simple ways to generate an estimate of the magnitude of the expected allocative and dynamic efficiency benefits. For example, the efficiency effects of a merger or regulatory intervention are often estimated as part of processes before the Commerce Commission. Because the Covec report explicitly states (e.g., at page 3) that it has not quantified dynamic efficiency, we focus on that. The techniques the Commission has adopted for quantifying the effects of mergers on dynamic efficiency are very straightforward – it tends

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[5] See for example page 66: "We believe that the improved price signals will allow pipeline users to make better investment decisions (in systems to better manage their individual imbalance positions) and potentially increase competition for the supply of other forms of flexibility."

[6] In line with our earlier comments on the same matter, we specifically disagree with Covec's concluding remark (page 22) that "The main benefits are from reduced balancing costs and reduced usage of fuel gas to support nominations."

[7] Draft Recommendation, page 40.

[8] GIC explicitly recognises this on page 42 of the Draft Recommendation: "We agree with Covec that MDL's total balancing costs should decrease, but *there will be a redistribution of those costs*… [And any increase in cost users face] will be a better reflection of the total cost of service to those users, including Line Pack flexibility…"

[9] Having said that, when Dr. Small was asked at the 11 March workshop whether he agreed reduced cross-subsidisation would improve allocative efficiency, his answer was affirmative; Dr. Small noted that in his presentation he'd characterised this as an unquantified dynamic efficiency gain. This may just be a case, then, of articulation in the report itself, rather than a substantive issue.

to simply multiply the annual market revenue by a percentage ranging between 0.5% and 1.5%.[10]

13 Accordingly, one approach in the present case would be to take the annual flexibility market revenue and multiply it by the percentage range. There are probably various ways to estimate the revenue of the flexibility market. For example, using the per GJ discount for an interruptible contract versus a non-interruptible contract, or the higher price paid for swing gas.

14 However, this might underestimate the dynamic efficiency benefits of mbb, which would have a positive impact beyond just the flexibility market. For example, the Amendments would increase spot market liquidity, as Covec acknowledges. This would in turn result in:

- more efficient price discovery, i.e., the spot price would more quickly reflect changing demand and supply;
- narrower spreads and less volatility;
- the ability to trade unders and overs, and relatedly, an improved source of direct flexibility. Indeed the combination of a more liquid spot market and a more efficient flexibility market should lower contracting costs; and
- lower risk for investors in gas fields and other specific assets.

15 To account for the fact that the efficiency gains would manifest beyond just the flexibility market, and into the broader wholesale gas market (and maybe further), the revenue of the wholesale market could be multiplied by the percentage range. Taking an approximate revenue figure of $1 billion and the percentage range adopted by the Commission, the annual benefit would be $5-15 million.

3.2 Increased barriers to retail competition?

16 Trustpower has argued that the adjustment factor creates a barrier to entry for smaller retailers. The argument is that smaller retailers find it harder to manage demand volatility and so are more likely to be cashed out. A cornerstone of the mbb CR is that the causers of imbalance should pay the costs of it. If a party has a relative inability to manage volatility, then under the status quo that will impose relatively higher costs on the pipeline user community – and, as a matter of allocative efficiency, that party should bear those costs (creating an incentive to reduce them). As GIC acknowledges, "it is unreasonable to expect that other pipeline users should meet the cost of providing flexibility to users with excess imbalance, as they do at present."[11]

17 There is a broader point to be made here. Managing risk is a cost of doing business as a retailer, and firms should face the true costs (as paragraph 12(c) of the GPS confirms). Any shielding of retailers from market forces is a matter of Government policy; if the Government wished to do so, it could amend the Act and GPS. In the absence of such change, we are left with the current (relevant) objectives which, taken together, can be distilled down to one imperative: efficiency. Once again – if a party whose costs have hitherto been suppressed by cross-subsidisation subsequently has those costs more fully brought to bear, then that is a

[10] See, for example, Commission Decision No. 725.
[11] Draft Recommendation, page 41

more efficient outcome and welfare enhancing for the community. And this efficiency logic applies equally to smaller and larger market participants alike.

3.3 Adjustment factor

18 Another matter which came up at the recent workshops is the adjustment factor. GIC and Covec both support its inclusion in the mbb CR. Its purpose, as we noted in our initial submission, is to incentivise primary balancing. Covec recognises this:

> *In the absence of the adjustment factor, cash-outs would simply price the imbalance gas at the prevailing market price so that pipeline users would be approximately indifferent as to whether they were cashed-out or not… In the absence of an adjustment factor, the difference between these prices would provide an incentive for primary balancing, but only in one direction [depending on the shipper's GSA price]. We therefore agree with MDL that incentives for primary balancing would not reliably increase without an adjustment factor.*[12]

19 Covec later goes on to discuss the narrower spreads (on the emsTradepoint market, relative to the BGX) – which it rightly characterised as a benefit of the mbb CR. It then observed that "An adjustment factor of 4% would not change that fact."[13] At least two shippers have put forward the notion that, while 4% may not be problematic, if MDL set the adjustment factor at 10%, that could somehow be inefficient.

20 GIC explicitly considered the "reasonableness of the 10% adjustment factor" on page 41 of the Draft Recommendation. Having identified various stakeholder views on the matter, GIC repeats its earlier conclusion that the adjustment would create an effective primary balancing incentive. It then goes further, noting that "10% (upper limit) is a reasonable adjustment to average market prices and is sufficient to encourage good balancing behaviour without being needlessly punitive," contrasting the upper limit with scheduling penalties of up to 50% of delivered gas prices, which are not uncommon overseas for imbalances above a certain threshold. We support and reiterate that conclusion, while also noting that our intention remains to set the adjustment initially in the 2.5-4% window.

3.4 Market fees

21 Trustpower argues that market fees should be factored in as a cost in the analysis. While we can understand Trustpower's point of view, we disagree with its conclusion. First of all, market fees are analogous to any other costs users incur – personnel, systems, etc. – to avoid being cashed out. They will only be incurred if the user expects to receive a larger benefit in return. Second, if any expected increase in market fees were included in the analysis, the corresponding benefits (which have not been fully identified by Covec) would also need to be quantified and included. There may be certain BGX-related savings here, over time, but the key benefits are those that follow from increased market liquidity (refer paragraph 14 above).[14]

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[12] Covec, section 3.1.5, page 14. GIC notes (section 2.4, page 20) that the adjustment provides an incentive which would improve primary balancing, adding also that the adjustment signals that borrowing gas or leaving it in the pipeline creates costs. GIC continues on page 41 that "We believe that it should be an effective incentive."

[13] Covec, section 3.1.5, page 15. Covec also notes, in Table 1 on page 17, that "The adjustment factor is too small to offset the efficiency improvement of moving from the BGX to a more liquid spot market."

[14] Covec (section 3.1.6, page 15) recognises these benefits, albeit somewhat baldly and without quantifying them: "We expect a much larger number of market transactions under a daily cash-out regime, which would improve the liquidity and hence efficiency of the emsTradepoint market."

3.5 Market benefits

22 It would be unrealistic not to expect some costs to be involved in establishing a robust spot market; and for a return on that investment not to be obtained through market fees. However, this needs to be seen in perspective: market-based balancing will create a significant net benefit.[15] There is a reason Government policy mandates the pursuit of efficient wholesale trading arrangements. And there is a reason why more advanced gas markets overseas are moving in a similar direction. A more efficient market ultimately means lower delivered gas prices to end users.

4 Incidental matters

23 There are several features of the Draft Recommendation that are incidental to the central enquiry, but nonetheless worthy of brief comment.

- *Lower cost OATIS replacement*: We agree with GIC, as a general principle, that "alignment with common overseas industry practice would bring a benefit…in relation to the OATIS replacement."[16]
- *Relevant GPS outcomes*: GIC, when listing "outcomes in the GPS that…are relevant to [its] evaluation", omits the objective listed in paragraph 12(c): "The full costs of…transporting gas are signalled to consumers." The Draft Recommendation implicitly accepts that this objective will be furthered by recognising that the costs of using (inter-day) Line Pack flexibility would be better signalled under mbb. In particular GIC observes that, to the extent "those who rely on Line Pack flexibility…experience an increase in cost…that cost will be a better reflection of the total cost of service to those users, including Line Pack flexibility…"[17] We therefore submit that this outcome should be listed in the Final Recommendation.
- *MPOC not a multilateral agreement*: Covec (page 4) characterises the MPOC as "a multilateral agreement," which is incorrect. Rather, the MPOC is a set of terms incorporated by reference into various bilateral agreements – namely TSAs and ICAs – between MDL and Shippers, and MDL and Welded Parties, respectively. This is not relevant to GIC's assessment but struck us as an incidental misconception worth addressing.

5 Next steps

24 If the Final Recommendation is handed down as planned on 27 April, and, as in the Draft Recommendation supports the mbb CR, we expect to be able to implement the Amendments on 1 July. While a 1 June implementation would be possible, we understand industry would prefer to have another month to prepare; this also creates a neater fit with MDL's tariff year.

25 In addition, we intend to consult on several relevant work streams – revised Standard Operating Procedures, MDL's plans for setting the default rule and Intra-Day Cycle times. We will shortly contact stakeholders with our proposed timetable and invite feedback.

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[15] Admittedly we have not gone as far as commissioning our own full cost-benefit analysis in order to propose a rigorous projection of what that benefit will be. However we have put forward some suggestions in Chapter 3.1 above on how efficiency gains might be quantified.

[16] Draft Recommendation, section 5.7, page 62

[17] Draft Recommendation, page 42

6 Concluding remarks

26 MDL supports the Draft Recommendation and generally agrees with GIC's reasoning. We also agree with the bulk of Covec's report. Our main residual concern is that Covec's analysis – and to a lesser extent, GIC's – underplays unquantified efficiency benefits, thereby understating the total net benefit expected to manifest following implementation of the Amendments. We have highlighted one or two other, minor concerns in this submission, but trust these submissions do not detract from the first point: MDL supports the Draft Recommendation and looks forward to the final iteration.

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