MDL Submission
on
Gas Industry Company
Retail Competition and Transmission Capacity:
Statement of Proposal

10 December 2010

A. Introduction

Maui Development Limited (**MDL**) welcomes the opportunity to make a submission on the Gas Industry Company's (**GIC**) Retail Competition and Transmission Capacity: Statement of Proposal, dated 12 November 2010 (**Capacity Proposal**). It is intended that this submission is read in conjunction with the Capacity Proposal.

The Capacity Proposal was developed by the GIC as a short term response to evidence of anti-competitive pressures on Vector's northern pipeline. Recommendations are intended to be applicable to both Vector's transmission pipelines, and the Maui pipeline.

This submission makes the following points:

1. The health of the market for gas in the Auckland area is of ultimate concern to MDL because it affects gas transmission demand through the Maui Pipeline.
2. For this reason, MDL is concerned about factors affecting competition and demand in the Auckland region.
3. MDL is equally concerned that the solutions considered for alleviating competition problems take account of the need to encourage further investment and move further towards good international gas practice.
4. However MDL is concerned that the GIC appear to be advocating regulation at this stage given that:
    a. There is very little hard evidence presented in the Capacity Proposal to support the conclusion that regulation is necessary.
    b. The costs of regulation appear to be under-estimated.
    c. The regulation proposed appears to apply to the Maui Pipeline, but its form is inappropriate and unworkable for the Common Carriage regime used by the Maui Pipeline.
5. MDL believes that if an industry negotiated solution is not possible, the GIC will need to:
    a. Provide sufficient evidence of an anti-competitive situation on Vector's northern pipeline to justify regulation.
    b. Consider other means to fully utilise the available capacity of this pipeline.
    c. Consider carefully whether any regulations it recommends can validly apply to other pipelines, such as the Maui Pipeline, and if not restrict their scope accordingly.

MDL's answers to the questions posed in the Capacity Proposal are attached. The following sections expand on the points made above.

B. The Problem on the Northern Line

B.1. Lack of Guaranteed Capacity

Insufficient physical capacity on a pipeline can only be remedied by building new infrastructure or by taking action to reduce the actual demand. The problem being tackled by the current GIC paper relates to the allocation of guaranteed capacity in a pipeline that may be running at less than its physical capacity for a substantial portion of the year. Retailers unable to offer guaranteed capacity

to a customer will usually be squeezed out of the market because they can only offer a gas supply that may be subject to interruption.

Since no more firm capacity is available for allocation, retailers without sufficient firm capacity are unable to compete in the market and this has the potential to reduce competition in the market – as has been noted by the GIC in the Capacity Proposal.

The GIC's preferred solution stated in the Capacity Proposal is to have "capacity following the user", and therefore allow retailers with lower price expectations to bid for existing business. While this proposal will restore competition in the market to some degree, it does nothing for new customers who do not have existing supply arrangements. They can either accept an interruptible supply or wait until additional capacity is made available or relinquished by an existing user. Because it transfers guaranteed capacity between users, it also does not deal with the problem of making sure that the actual physical capacity of the pipeline is fully used. It deals with only part of the problem and, as recognised by the GIC, must be supplemented by additional action later.

B.2. Complicating Factors

This brings us to the description of "grand-fathering" rights. The GIC has noted that they were put in place to allow multi-year contracts to be offered to end users, but not intended to limit their ability to select their preferred gas supplier, or confer market power on holders of firm capacity. There are other reasons for these rights which relate particularly to large end users and electricity generation stations in particular. In these cases "grand-fathering" rights to firm capacity are used to ensure that the plants using the gas can be run at capacity when they are required to do so. Where electricity generation plants are involved for instance, removing or reducing these rights could have serious consequences for the security of electricity supply. We understand that a substantial part of the Northern line guaranteed capacity is in fact allocated to electricity generation plants.

Multi-year firm capacity allocations are worth little to the end user in the early years when a pipeline is running well under capacity although they provide the pipeline owner with guaranteed revenue. They have real value at the point where the pipeline approaches capacity, but this is just the point where such arrangements can be criticised as being anti-competitive. Any party that has paid for a given level of firm capacity for a number of years would have every right to feel aggrieved if its entitlement is reduced; just at the point where having it becomes critical.

MDL does not agree that grandfathering rights were "not" intended to convey some advantages to some retailers over others. It cannot be said that such advantages could not have been reasonably foreseen by retailers when decisions to take up additional capacity were made. The GIC state that capacity was purchased to allow incumbents to sign long term contracts. Incumbents would unlikely be prepared sign long term contracts if they were of the view that their long term supply would be voided as soon as a shortage was discovered.

MDL does not suggest that grandfathering rights should be preserved at any cost. It does however suggest that a clear (and quantifiable) case needs to be established before any alteration of existing contractual rights is contemplated.

B.3. The Longer Term

The Capacity Proposal offers an immediate short term solution while noting that further action will probably be needed later on.

MDL believes that attention needs to be given to introducing a daily nominations regime backed up with appropriate metering to measure actual quantities and a scheme for adjusting nominations when the pipeline capacity is exceeded. This will enable the physical capacity of the pipeline to be fully allocated. Given the fact that the physical capacity of the line is apparently approached on only a few days a year, this would allow additional transmission capacity to be allocated. It would also move the operation of the pipeline nearer the principles enshrined in good international practice and provide benefits in a number of other areas such as the allocation of balancing costs.

Decisions on the order in which customers would be curtailed in over-capacity situations could be made in a number of ways. One possible element of any solution would be to let the cost of guaranteed capacity rise to reflect the fact that it is scarce. A higher price for capacity should encourage investment to increase its supply and reduce the propensity to hoard, however it may also result in increased wholesale and retail gas prices. We are well aware of the arguments to the effect that gas pipeline owners may profit when this happens, but their returns are soon to be regulated. On the other hand, artificially low prices for the provision of guaranteed capacity are not likely to encourage investment and will perversely encourage growth in demand.

C. The Regulation Proposal

C.1. The Need for Evidence

MDL does not believe that the evidence of anti-competitive behaviour presented in the Capacity Proposal is sufficient to justify regulation at this point. In MDL's view the problem has to be shown to be severe to warrant any intervention that overrides existing contractual rights. Intervention cannot be justified on the basis of one or two isolated occurrences. This qualification also makes it necessary to explore the impact that cancelling contractual rights might have on new investment, which will be the only solution as demand grows past the physical capacity of the pipeline. MDL would have preferred the Statement of Proposal to focus on developing a framework for gathering information to build the case for intervention. It would also prefer that any regulation recommended as a result of such a study be carefully targeted to avoid unintended consequences elsewhere.

At some later stage the need for additional investment must also be considered. We note that the Commerce Commission has not yet been able to provide a robust framework for measuring whether investment is required. This would require that the Commission make both quantitative and qualitative[1] assessments. MDL feels that the GIC, with its in-depth knowledge of the gas industry would be in an ideal position to assist the Commission to develop this necessary framework.

C.2. The Cost of Regulation

The regulatory proposal in the Capacity Proposal is likely to be resisted by a number of the affected parties leading to delays and increased costs of implementation. In MDL's view, the assessed cost of implementing the proposal is considered to be too low even for a situation where the change is supported by the majority of industry participants. In coming to this conclusion MDL has considered the costs of implementing the Critical Contingency Regulation and the proposed Balancing Rules.

If it turns out we are wrong in believing that the solution in the Capacity Proposal is likely to meet resistance from a significant number of users of the pipeline, then a Vector Transmission Code (**VTC**) change would be relatively inexpensive and simpler to implement if 75% approval can be obtained.

[1] Particularly in relation to service reliability

D. Applicability to Maui Pipeline

D.1. Provisions for Dealing with Constraints on the Maui Pipeline

MDL is concerned that the regulations proposed in the Capacity Proposal will apparently, (and perhaps unintentionally), also apply to the Maui Pipeline. The Maui Pipeline operates under a Common Carriage based regime. It is not currently in a constrained state. Under the Maui Pipeline Common Carriage regime all users have equal access to capacity, subject to the AQ provisions discussed in more detail below.

The Maui Pipeline is considered to have no effective delivery constraint south of the Mokau Compressor Station. The capacity of the Mokau compressor is the physical constraint for delivery of gas north of Mokau. Under normal operating conditions, with one compressor running and a second compressor utilised in reserve, 330TJ per day is considered to be the maximum amount of gas deliverable north of the Mokau compressor. If Shippers nominate more than 330TJ in a day, curtailment of nominations may be expected. It is important to note that a capacity curtailment has not occurred on the Maui pipeline since the start of Open Access.

Given that all gas flows are nominated in advance, determining whether a constraint exists on the Maui pipeline is relatively simple. If nominations exceed capacity, MDL is required to undergo a capacity curtailment. The total quantum of capacity curtailment can easily be calculated and the relevant provisions in Section 8 of the MPOC applied. Ordinary nominations are pro-rated in proportion to each party's Net Historical Usage, which in turn is related to the sum of nominations over the previous 12 months.

D.2. AQ Provisions

Section 7 of the MPOC provides for a quasi contract carriage service known as AQ, (Authorised Quantities). Section 7.3 of the MPOC requires that up to 70% of capacity of the pipeline be available to shippers whom wish to hold AQ. Where a shipper holds AQ, nominations which are assigned AQ privileges will enjoy priority over non AQ, (or ordinary), nominations where there is a capacity curtailment or pipeline curtailment. However AQ does not have priority under any curtailment caused by a Welded Party outage.

It is very unlikely that AQ nominations would be affected by a pipeline constraint as MDL is not allowed to issue AQ capacity for more than 70% of the total pipeline capacity in each AQ zone. Since AQ nominations get priority over ordinary Common Carriage nominations the effect of constrained transmission will be to reduce the capacity available for ordinary nominations, (unless the capacity of the pipeline has been greatly reduced from its normal level for some reason). The capacity available to ordinary nominations will then be pro-rated according to the Net Historical Usage rule.

A shipper holding AQ is required to pay the AQ fee whether or not the AQ privilege is used. In addition AQ is not considered attractive in terms of tradability and these two factors should act to discourage hoarding.

The AQ provisions in the MPOC are yet to be activated. MDL notes that the commercial terms governing the conditions under which the AQ product will be offered to Maui Pipeline shippers are not specifically addressed in the MPOC. Before being introduced, the queuing rules, which will be an important part of these terms, must be provided to the GIC for its consideration and approval. If "grandfathering rights" are offered as part of these queuing rules and are considered to be anti-

competitive the GIC will have ample time to consider the matter before coming to a conclusion. Regulation to cover this process is unnecessary.

D.3. Need for Regulation of Maui Pipeline Capacity Allocation

In these circumstances we do not see how the proposed regulations can improve matters substantially in terms of their effect in the distribution of ordinary nominations. Allocation according to usage over the previous 12 months seems reasonable to us and has been previously agreed by the Industry. Also since the pro-rating of nominations is an automatic function of the OATIS software, which has been programmed to follow the MPOC rules, any regulations that change these rules will cause a great deal of difficulty and cost in that their effect will have to be programmed into OATIS in advance. Running manual adjustments to nominations for four ID cycles a day will be an extremely difficult task. To summarise, we see little benefit in this area, but a great deal of cost.

E. Supporting Investment

Constraints due to lack of physical capacity can only be solved by additional investment. MDL notes the emphasis given by the GIC and the Commerce Commission to holding gas prices down and limiting the returns available to pipeline operators. These are worthy objectives when their intention is merely to limit excess. Applied too vigorously they reduce the incentive to invest in new capacity as there will be better returns available elsewhere for the capital required. Any overall economic assessment needs to take into account the lost opportunities resulting from a failure to expand the gas supply as well as the visible costs to gas users.

Retail Competition and Transmission Capacity: Statement of Proposal- format for submissions

Company name: Maui Development Limited

To assist the Gas Industry Co in consider stakeholders' responses, below is a suggested format for submissions. The questions are the same as those contained in the body of the document. Respondents are also free to include other material in their responses.

QUESTION	COMMENT
Q1 Do you agree with our description of the retail competition problem?	Yes, as far as it goes. MDL believes that a much more substantial case needs to be made to justify regulation.
Q2 Do you agree with the economic analysis?	We believe the situation is actually more complex than shown. It seems that a lot of the incentive to hold onto guaranteed capacity is due to the size of over-run fees and the relatively low cost of holding guaranteed capacity.
Q3 Do you agree with the proposed regulatory objective?	MDL believes the objective should require evidence of consistent anti-competitive results. Our alternative wording is; "*To ensure that, in the short term, end users who are able to be supplied by existing pipeline capacity are not* ***consistently*** *prevented from having access to* ***alternative suppliers****. The solution should not compromise achieving the Gas Act and GPS objectives in the longer term*" MDL also advocates a qualification that requires any interference with contractual rights to take into account the effect on new investment incentives.

QUESTION	COMMENT
Q4 Do you consider that the evaluation criteria are appropriate for evaluating the options?	In general, yes. However we note the tendency to opt for "middle of the road" solutions where competing criteria exist. For instance the GIC's earlier selection of the "hybrid solution" as its preferred capacity regime was underpinned by its "medium" rating on; "the extent to which the regime is contract carriage"; AND the "extent to which the regime is common carriage. In fact it was neither and the positive benefits of each extreme regime were foregone.
Q5 Do you have any comments on the evaluation of options?	MDL does not agree with the priority of objectives. It appears to MDL that the GIC, faced with the competing objectives of "competition" and (preservation of) "existing contractual rights", has downgraded "existing contractual rights" as an objective to ensure the results are in line with its predetermined preferences. MDL does not agree with the low weighting given to "existing contractual rights" for the following reasons: o Cancellation of contractual rights will be met with significant opposition. This will undoubtedly place upward pressure on implementation costs. o Cancellation of contractual rights might discourage investment in infrastructure. Users with eroded contractual rights may change their investment policy relating to gas powered plant. MDL is of the view that cancellation of contractual rights is not an action to be undertaken lightly and that this objective should be extended a heavier weighting.
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?	MDL agrees that GIC's suggested solution might be warranted in the specific case of the Northern Pipeline once the GIC have clearly established and quantified the existence of significant anti-competitive behaviour
Q7 Do you have any comments on the details of the proposal?	See our submission.

QUESTION	COMMENT
Q8 Do you agree with the next steps?	The next steps should involve a paper which establishes an information framework to quantify the extent of the competition issue on the Northern Pipeline. As far as the Maui Pipeline is concerned, MDL is prepared to assist the GIC in terms of establishing a framework that is relevant to its operation if this is considered necessary but it does not believe that this framework would necessarily be relevant to Vector's transmission pipeline.