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Nova Gas Submission re Transmission Pipeline Balancing Issues Paper.

Question 1: Do you agree that the ERGEG guidelines are appropriate to use as a framework to evaluate alternative balancing market design options for New Zealand?

Yes, although we note the following considerations:

- The principles are guidelines and are not a “paint by numbers” guide to market design.
- There is no priority order or ranking of principles. If there was to be an overriding principle it would be one of economic efficiency.
- Achieving the objectives of the principles will require tradeoffs and resolution of conflict or compromise.

The ERGEG principles are a high level guide only that is based on European experiences. The European gas market has many pipeline owners, many consumers many producers and also multiple markets for balancing, short term spot and longer term gas requirements. This means that competition is able to drive many improvements in market arrangements.

New Zealand on the other hand has a small immature market with two major pipelines systems so there is no ability to leverage off competing arrangements and transmission systems.

This means that it is more likely that there will be conflict between different principles.

A good example of this is the conflict between:

- The principle that pipeline users are primarily responsible or balancing with the TSO picking up a residual obligation; and

- The principle that balancing charges are cost reflective – ie based on competitive market prices; and
- The principle that network users should have timely information to corrective actions

If balancing charges are truly cost reflective and based on competitive market conditions then there is little incentive or ability for a pipeline user to procure balancing services themselves at a better price. In fact, the TSO procuring balancing services may be able to do it more efficiently through reduced transaction costs.

If the costs of acquiring the necessary information to allocate gas demand are costly, then again it may be more efficient to procure balancing gas and provide for hedging as suggested in Appendix C of the Issues paper.

It is our view that where principles conflict with one another then a cost/benefit approach should form the basis for determining which is the best solution. No one principle should be given more weighting and in considering which is the most efficient balancing solution the viewpoint should be from the market perspective and not just an element of the market such as the either of transmission, supply or demand perspective's.

Question 2: Are there key issues not identified in Chapter 6?

No.

Question 3: Are there any additional design elements not identified in Chapter 7, which you consider should be addressed?

7.2 Balancing responsibility

Residual Balancing Role

Paragraph 7.2 notes the inefficiency of attempting to eliminate the residual balancing role completely. We agree with this view as it is in the best interests of gas producers, gas consumers and gas transport companies to maximise the quantity of gas bought, sold and transmitted which may be contributed to through efficient balancing mechanisms.

Market arrangements that are inefficient will impose unnecessary risks and costs on suppliers and consumers that will make gas less attractive at the margin compared to alternative fuels or will encourage gas producers to bypass gas pipelines.

If Pipeline balancing arrangements mean that gas users switch to alternative for fuels or act to bypass gas transmission by locating electricity plants closer to gas fields for example, then this will be an inefficient use of sunk investment in pipelines. It should be noted that monopoly pipelines are not entirely protected from the affects of reduced flows of gas through pipelines as under the current regulatory regime, optimised deprivation valuations of pipelines will also be reduced with lower throughput volumes.

An efficient means of managing balancing is required to prevent such outcomes and to ensure that there are not any unnecessary barriers to gas competing as a fuel.

Single Balancing Agent

While it may be true that it is efficient to have only one balancing agent in the New Zealand context, we believe that this should stop short of preventing other parties offering a balancing service if a Balancing Agent is selected.

If a single balancing agent was to be appointed to a pseudo monopoly position then without the tension of potential competition, monopoly rentals can be extracted.

We note that currently the Vector Transmission Code does provide potentially for a balancing tender process that if activated, could fill this role. A decision regarding Vector Transmission's own balancing capability could depend on factors such as transaction costs of alternatives.

We would not recommend that the industry appoint a single balancing agent with exclusive rights to the provision of balancing services for the industry. Such an approach would not only prevent reductions in transaction costs through time but would also inhibit innovation and the development of new services.

7.5 Incentives on Pipeline Users

The issues paper proposes that users will be able to balance themselves in all cases at a cost lower than what a balancing agent might. This is not necessarily the case as the transactions costs for each individual user to access balancing gas may be higher than those incurred by through a common industry arrangement. If it is required by a balancing agent to apply a punitive transaction charge in order to discourage pipeline users from using the residual balancing service then this conflicts with the principle of cost reflectivity.

Mechanism for procuring gas and determining prices

MDL has proposed a two tiered structure of Operational Balancing Gas and Secondary Balancing Gas the w believe will be operationally difficult to administer especially when the intra day Operational Balancing Gas function moves to a competitive process involving multiple providers.

The linkages between Operational Balancing Gas and Secondary Balancing gas will become extremely complex and transaction costs will be high.

Liquidated damages regime

We agree with the views that explicit recognition of balancing charges and their pass through to causers is a fundamental prerequisite for investment in spare production or storage capacity. If those costs are not explicitly recognised and pipeline users have no incentive to acquire balancing services, then there will be insufficient investment in the assets required to provide those services. This in turn will lead to issues with security of supply, as its value is never truly recognised.

Regarding the proposal to introduce a double sided incentives pool, we believe that this may not be easily done as the liquidated damages regime using electricity as a pre estimate of loss for consumers who are curtailed during a shortage event may not be a good pre estimate of loss for producers who are curtailed when there is an over supply. In such a case, a supplier who is curtailed due to another suppliers over production is likely to receive a low price electricity equivalent gas price as

compensation. We believe that an electricity price equivalent is not a good pre estimate of loss to a curtailed producer and as such, a liquidated damages regime may not be the best mechanism for dealing with this situation.

Pricing based on marginal or average costs

Regarding the issue of suppliers of balancing service providers being paid the marginal price of the price they offer, the selection of either will affect how providers submit bids to the balancing agent.

If the provider is going to receive their tendered price (as opposed to a marginal price) then they must attempt to guess what the clearing price is and offer that price. This will be done regardless of what their actual cost of production or short run marginal cost (SRMC) actually is.

Under a marginal price mechanism, the supplier is incentivised to offer the product at their variable cost of production or SRMC and they do not have to guess what the market clearing price will be as they automatically receive it.

Marginal pricing is generally considered to be the most economically efficient mechanism in commodity markets as it provides for parties to simply price at their SRMC.

Trading and cashout of imbalance positions

Nova believes that this trading of imbalance positions is ineffective.

Ex ante trading of positions can happen currently and there are several mechanisms including nominations and Gas Transfer Agreements that facilitate this currently such as displaced gas nominations and Gas Transfer Agreements.

Ex post trading is ineffective as balancing costs have already been crystallised and the only issue to be resolved afterwards is who bears the costs. This means that the act of trading a position ex post does not reduce balancing charges – just shifts them from one party to another and as a result there are weak incentives for this form of trading.

Information on balancing prices

We note that the footnote at the bottom of page 49 states that the Vector pipelines do not have producers injecting gas into them is incorrect. In fact there are several producers on Vector transmission lines including:

- Kapuni
- Rimu
- TAWN

In addition, Kupe will be connecting to Vector transmission lines some time in 2009.

We note that the balancing gas contracts proposed by MDL effectively exclude any party connected directly to the Vector transmission system as MDL will only deal with welded parties. Large users or producers on the Vector system are excluded and this represents a barrier to entry for those participants and results in a reduction in competition in the balancing services market.

Regarding TSO's forecasting system demand, we have no doubt that at an aggregate level accurate demand forecasting is possible. The problem is the allocation of the demand forecast among the retailers active at each welded point or gate. Accurate allocation or allocation that is not potentially distortionary will be difficult given that retailers are not necessarily active in all market segments and in all geographical areas.

Question 4: Are there any balancing regimes which you consider Gas Industry Co should include in its forthcoming analysis work?

Given the slow progress being made under the status quo industry governance regime, we believe that a regulatory backstop option needs to be developed and deployed if necessary.

It may be that the design work being performed as a part of the regulatory process will be incorporated in industry governance arrangements such that regulation may be forestalled.

Nova believes there are two options for the industry to pursue:

- 1) balancing market with marginal pricing providing for welded parties and shippers to "hedge" their position as suggested in Appendix C of the issues paper. This option means that less certainty on retailers daily demand is required.
- 2) Daily allocation of demand for all retailers with retailers primarily responsible for balancing their position. This will reduce reliance on the development of a balancing market mechanism as all retailers will be better placed to manage their daily supply/demand balance directly with suppliers.

Both options have pros and cons should be explored in more detail.