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**Trustpower submission on whether the final GTAC is “materially better” than the current terms and conditions for access to and use of gas transmission pipelines**

**1 Introduction**

- 1.1.1 Trustpower Limited (**Trustpower**) thanks Gas Industry Co (**GIC**) for the opportunity to submit on the new Gas Transmission Access Code (**GTAC**) developed by First Gas to replace the current Maui Pipeline Operating Code (**MPOC**) and Vector Transmission Code (**VTC**).
- 1.1.2 Trustpower supports the development of an open and compatible transmission access arrangements across both pipeline networks.
- 1.1.3 We note that this has been a policy objective of Government since the ACIL report<sup>1</sup> was issued in 2001.
- 1.1.4 In developing our views on the GTAC, we have been guided by the advice of The Lantau Group.
- 1.1.5 Their most recent report “Assessing the GTAC: Lingering Issues (January 2018)” is attached as an appendix and should be read as part of our submission.

**2 Trustpower’s views**

- 2.1.1 The 2008 Government Policy Statement (**GPS**) requires that gas industry participants and new entrants are able to access the transmission pipeline network on the basis of reasonable terms and conditions.
- 2.1.2 As a result, we are of the view that whether the terms and conditions of access are reasonable needs to be considered as part of the GIC’s assessment of the GTAC.
- 2.1.3 This is reinforced by the advice of the Lantau Group<sup>2</sup>:  
*“Once one commits to a complex and resource intensive evaluation process, the little things matter. It is not enough to be satisfied just when it appears that benefits exceed costs. One should ensure that there is not some easily fixed issue that would make things even better. In short, an economically efficient process does not stop just at the point when benefits exceed*

<sup>1</sup> ACIL Consulting: *Review of the New Zealand Gas Sector. A Report to the Ministry of Economic Development*, October 2001

<sup>2</sup> The Lantau Group, *Assessing the GTAC: Lingering Issues (January 2018)*, (**Lantau report**) page 6

*costs but rather only after one is satisfied that further costs of improving upon an option are no longer worth incurring.” Whilst acknowledging the efforts First Gas has put into developing a unified access code across both transmission pipeline networks, we do not consider that the final GTAC presented by First Gas to the GIC for assessment establishes reasonable terms and conditions for transmission pipeline access.*

- 2.1.4 Our reasons are set out in the balance of this submission.

### 3 Nature of reasonable terms

- 3.1.1 Under the Gas Act, the principal objective is to ensure that gas is delivered to existing and new customers in a safe, efficient, and reliable manner.

- 3.1.2 The Lantau Group notes that *“such principal objectives are so high level as to be unhelpful in any practical sense”<sup>3</sup>.*

- 3.1.3 They go further to state that<sup>4</sup>:

*“Ultimately, these often ambiguous, certainly numerous, and frequently overlapping objectives increase the difficulty of charting a course forward. However an essential aspect of these objectives is that they touch on common economic concepts.*

*An overarching practical distillation seems advised, especially given the multilateral impacts of the proposed GTAC.”*

- 3.1.4 The Lantau Group consider that the implications of any transmission access arrangements on competition and reducing barriers to entry is paramount<sup>5</sup>:

*“When thinking about objectives and evaluating various aspects of the proposed GTAC, the overarching perspective ought to be how well the changes facilitate competition as a way to promote discovery and integration of information and preferences that would otherwise have been ignored, overlooked, or left unacknowledged.”*

*“...options should be evaluated against whether they are in fact fully pro- competitive and consistent with economic principles or whether they in fact embed quasi-regulatory or non-market mechanisms to a degree that no longer justifies ex ante priority consideration relative to regulated solutions or hybrid market/regulatory solutions that deal with market failure or other unmanageable risks explicitly.”*

- 3.1.5 This is further supported by the following<sup>6</sup>:

*“In simplest terms, a preference for competition as a means of organising industry activity implies the intrinsic validity of giving higher weight and priority to changes that have the potential to enhance competition. Indeed it is the objective of enhancing competition rather than pursuing economic efficiency per se that best achieves the economic efficiency that might otherwise be pursued.”*

- 3.1.6 The significant differences between the NZ market context and that seen in other established gas markets, such as the US, that need to be considered in determining what constitutes

<sup>3</sup> ibid page 2

<sup>4</sup> ibid, page 3

<sup>5</sup> ibid, pages 4-5

<sup>6</sup> ibid, pages 4

reasonable terms and conditions of access to the transmission network are also established in the Lantau Group's paper<sup>7</sup>.

*"The most striking differences of the NZ gas market with the major integrated markets such as those found in Europe and North America lie in the number and diversity of both market participants and available contractual instruments to manage both operational and commercial risks.*

...

*the NZ gas market features much less depth and diversity of both participants and supporting infrastructure. Under such circumstances elsewhere as well as in NZ, both regulators and participants have valid reasons to seek alternative means of achieving as many of the positive features of competitive commodity/capacity markets as possible while reducing the complexity and associated costs of transaction risk management and pipeline capacity allocation.*

...

*Where simplifications in market structures, processes, or offerings are considered necessary given some limitation or constraint, it is not a matter of logically deferring to "market-based" solutions ahead of, or in priority to, regulated solutions. It is a case of identifying the most practically effective blend of both – holistically."*

- 3.1.7 Given the context, the Lantau Group consider that the original regulatory objective for transmission access defined by the GIC continues to be appropriate<sup>8</sup> as a basis for assessing the GTAC

*"To define a transmission access framework that facilitate competition in the upstream and downstream gas markets, recognising the natural monopoly characteristics of gas pipelines. [emphasis added]"*

## 4 Assessment of the GTAC

- 4.1.1 We have identified, supported by advice from the The Lantau Group and external legal advisers identifies four core areas where the proposed new arrangements fall short:

- a) Priority Rights;
- b) Rebates;
- c) Legal vehicle selected for binding multilateral obligations; and
- d) Mechanisms to enforce multilateral compliance

### *Priority Rights*

- 4.1.2 We do not consider the current design of the PR arrangements provide reasonable terms and conditions of access for a small retailer who predominantly supplies the mass market.
- 4.1.3 Nor do we consider that the proposed PR arrangements will enhance competition in the New Zealand gas market.
- 4.1.4 The Lantau Group note that *"The PR regime is dressed up in the right words, but the words do not fit the underlying reality"*<sup>9</sup>
- 4.1.5 The Lantau Group's report notes the following issues associated with the PRs design:

<sup>7</sup> ibid pages 1-2

<sup>8</sup> Transmission Access Framework Progress towards a Statement of Proposal (August 2007), Gas Industry Company Limited, p. 4.

<sup>9</sup> Lantau report page 4

- e) The PR regime skirts the essential ingredient of effective capacity markets globally – the existence of an obligation to deliver on the part of the pipeline operator.
- f) The pricing and impact of PRs on the market are subject to unusually wide ranging discretion by First Gas.
- g) The cost of PRs awarded in auctions by First Gas cannot be determined at the time they are awarded as the ultimate cost to a procuring stakeholder depends on a rebates mechanism.
- h) The PR regime remains largely unproven being still conceptual in design. Almost any relevant detail to resolve any of the above concerns is missing at this time.

4.1.6 As a result of these outstanding issues, the Lantau Group considers that the PR regime is a complicated proxy for regulation, not a market-based price discovery arrangement as suggested by First Gas<sup>10</sup>:

*“Consequently, in our view and given an overarching objective of enhancing competition, the proposed PR regime merits no special consideration or favouritism ahead of regulated approaches. Just because money changes hands (in this case, twice for each PR award) doesn't make a process a market. As proposed, we strongly caution that PRs are likely to become a complicated self-motivated, and anti-competitive private sector proxy for regulation, not a price discovery system incorporating innovative and value-enhancing market dynamics.”*

4.1.7 The Lantau Group goes on to comment on the cost-benefit assessment of the PR's regime undertaken by Sapere Research Group, noting<sup>11</sup>:

*“...Sapere makes the point that in the short term PRs are “unlikely to have a lot of value” to shippers “until there are actual or perceived shortages.” Accordingly, it would be nearly costless to delay PRs until some of the more challenging issues are worked through. Alternatively, it would be nearly costless to provide an alternative firm service product for mass market customers, leaving the PR regime to those stakeholders with more flexible and diverse usage characteristics.”*

4.1.8 The Lantau Group strongly encourages the GIC to consider the implications of the GTAC design at a disaggregated level rather than *en bloc*, and notes that the current design of PRs may have significant competition implications that require detailed consideration by the GIC<sup>12</sup>:

*“It is wrong to apply a simplistic test to determine whether to accept the GTAC en bloc when there are constituent components that remain problematic and are likely to have relatively easy (or high value) fixes.*

*This is the crux of the problem with PRs. They are neither a market-based regime nor do they comprehensively address the problem of capacity value under scarcity conditions. Consequently, evaluating PRs as if they are a market-based solution meriting a higher priority (pun intended) consideration over a regulatory solution is not justified.”*

*“The biggest risks posed by the PR regime are bound up in the way that the PR regime can punish small entrants and mass market retailers (but also others) – in a manner that reduces the prospect of enhancing competition – through (unnecessary) uncertainty of pricing and priority.”*

4.1.9 Given the issues outlined above, the Lantau Group recommends that a regulated firm service for access is required, at a minimum.

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<sup>10</sup> Ibid, page 5

<sup>11</sup> Ibid page 6

<sup>12</sup> Ibid page 7

4.1.10 This would be consistent with the GIC's previous access framework which included consideration of the principle that *"as far as possible, parties should only be responsible for risks that they can manage"*.

4.1.11 The Lantau Group notes<sup>13</sup>:

*"The problem is that PRs introduce risks that cannot be managed, particularly for mass market retailers and customers, and they do not allow for efficient management by any stakeholder (other than First Gas) of risks that do arise... We clearly see this as a serious problem.*

*But most importantly, those who actually need the capacity to serve inelastic customer demand would not have any way ex ante to manage the cost risk associated with exposure to PR costs (net of recycling). The absence of an ex ante firm product with a known ex ante firm product price introduces an extraordinary open-ended risk to the mass market. It may not happen often, it may be less than we worry about, but one does not prudently plug an open-ended commercial risk with prayer.*

...

*All that would have to be done in the short term is offer mass market default PRs at some estimated premium price that is fixed and firm and inviolate. If the rest of the industry is able to manage the proposed PR regime risk, then so be it, otherwise work could also get started to develop an actual firm capacity rights product that is extended through all customer classes to replace a combination of default and traded PRs."*

4.1.12 Taking into account the Lantau Group's advice, we consider that the lack of a firm access product for supplying mass market customers will have adverse competitive implications for the New Zealand gas market.

#### **Rebates**

4.1.13 We also believe that the proposed rebate regime will introduce distortions into the GTAC design.

4.1.14 While we appreciate that First Gas considered our concerns and produced a detailed explanatory document on this matter, we do not consider the outcome is appropriate in light of the objective of promoting competition.

4.1.15 This has been further reinforced by the advice of the Lantau Group<sup>14</sup>:

*"Now, it is certainly true that there is a class of fees and surcharges seen in regulated settings where the economically efficient approach is to find a way to raise the associated revenue in the least distorting manner.*

...

*But this is not what overrun and underrun charges or PR regime revenues are all about. Such sources of revenue are very much exactly about the cost of providing services. And they are revenues that differentiate by stakeholder in accordance with things that each stakeholder does differently.*

*A rebate regime to reallocate the revenues from PRs, or from Daily Overrun Charges, Underrun Charges, Hourly Overrun Charges and Over-Flow Charges deals in value that derives from what stakeholders do on / need from the system. Rebating these revenues based on unrelated or irrelevant metrics unavoidably creates different marginal prices for*

<sup>13</sup> ibid page 10

<sup>14</sup> ibid page 8

*different customers for the same thing. Such an outcome is the antithesis of a “market mechanism” where the marginal prices or costs are a consistent market-wide phenomena against which all sources of demand and supply competitively respond and organise themselves.”*

- 4.1.16 In the Lantau Group’s view the proposed rebate mechanism fails a basic economic test – that is to keep each mechanism and incentive separate and non-polluting of other signals. As a result, the currently proposed rebate regime will not promote competitive outcomes. This is a significant commercial design issue that will need rectifying in order to ensure that reasonable terms and conditions of access to the transmission network are provided.

#### *Legal structure*

- 4.1.17 First Gas propose to impose its access code on shippers under a mirror bilateral contracts plus common code structure. No other options have been considered.
- 4.1.18 In the process to date with First Gas, we have raised concerns that this structure does not provide a reasonable basis for access to the transmission network.
- 4.1.19 A detailed account of our concerns was provided in our November 2017 response to First Gas on the GTAC. These included our views that:
- a) the rule change process may not deliver reasonable terms and conditions of access as effectively as a regulatory solution;
  - b) there are greater Commerce Act risks under an industry agreement as compared to a regulatory solution; and;
  - c) the dispute resolution processes are inadequate for an access code (discussed below);

#### *Multi-lateral compliance*

- 4.1.20 First Gas has responded to our concerns about the ability to enforce the common code with the introduction of complex subrogated and assigned enforcement rights.
- 4.1.21 This arrangement is a “work around” to address the lack of contractual nexus between shippers notwithstanding the fact that they are all bound to and affected by a common code.
- 4.1.22 Given the complexity of the updated subrogation proposal, we sought external legal advice on its scope and effectiveness.
- 4.1.23 That advice has confirmed our views that the “subrogation” clauses are ambiguous at best.
- 4.1.24 This is because while there is a clear intent to enable shippers to pursue other shippers to recover loss from events involving interconnected parties with no direct contractual relationship, the provisions as drafted do not appear to achieve this outcome.
- 4.1.25 Subrogation arises in a positive sense when:
- one party A (here, for example, a shipper – the **claimant party**) steps into the shoes of another party B (for example, First Gas – the **subrogated party**);
  - to enforce rights held by the subrogated party (First Gas) against third party C (here, for example, a defaulting shipper – the **defending party**);
  - to recover for an actual loss suffered by the subrogated party (First Gas);
  - for which the claimant party (the shipper) has indemnified or paid out for the loss to the subrogated party (First Gas).

The Court of Appeal has described subrogation in the following terms:<sup>15</sup>

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<sup>15</sup> *New Zealand Society of Accountants v ANZ Banking Group (New Zealand) Limited* [1996] 1NZLR 283

*Persons who exercise rights of subrogation do not acquire an independent cause of action and do not sue in their own right, since they are subrogated to the rights of the original claimant.*

- 4.1.26 The GTAC subrogation clauses fail to meet the essential requirements of subrogation at a key point. The claimant party/shipper will not have paid out or indemnified (and will have no reason to pay out or indemnify) First Gas for a loss suffered by First Gas.
- 4.1.27 This is because any loss suffered by First Gas will be fundamentally different to the loss suffered by the claimant party/shipper. The claimant party/shipper will only want to claim for their own loss yet have no basis on which to bring (in the shoes of First Gas) a claim against the defending party/shipper for the loss they have suffered themselves.
- 4.1.28 The GTAC subrogation clauses seek to overcome this shortfall by deeming:
  - the claiming party's loss to be First Gas's loss for the purposes of the TSA or ICA between First Gas and the Breaching Party (cl 16.12(c)); and
  - a breach of the breaching party's obligations under its TSA or ICA with First Gas as a breach by First Gas of its TSA with the claiming party (cl 16.12(d)).
- 4.1.29 However, the claiming party is pursuing the claim in the name of (and therefore standing in the shoes of) First Gas (cl 16.12(a)) – which does not make sense if First Gas is also deemed to both be the source of the contractual breach by the defending party C and the source of the contractual loss to claimant party A.
- 4.1.30 In reality the clauses, reflect an assignment of rights to bring litigation – but whatever terminology is used, there is room for argument as to whether the clauses work to enable the claimant party/shipper to recover for their own loss rather than the loss to First Gas.
- 4.1.31 To the extent this analysis is contestable, this highlights a further issue with the proposed compliance regime – any shipper seeking to rely on the GTAC subrogation clauses will first have to establish that the relevant clauses apply and mean a claim for loss they have suffered is possible, as well as establish the basis for the claim itself.
- 4.1.32 This will need to occur in private arbitration at the parties' expense. The costs of such private arbitration are likely to be prohibitive for smaller and new participants in particular – a typical arbitration involves paying both legal fees for compilation of evidence, and written and oral advocacy (including for the opposing party if a claim or defence is unsuccessful) and the costs of the arbitrator (which may be in excess of \$10,000 per day, depending on the arbitrator appointed).
- 4.1.33 As a consequence we are concerned that:
  - a) the costs of self-enforcement/dispute resolution by individual shippers may be too high for all but large shippers, and have the effect of exit, or non-enforcement;
  - b) this in turn dis-incentivises compliance overall and may have a negative effect on achievement of the underlying access objectives.
- 4.1.34 It would be much more reasonable for participants wanting to make a claim to simply make a call to the market investigator to make a claim of a possible breach of a GTAC provision.

## 5 Concluding remarks

- 5.1.1 In summary, we do not consider that the current version of the GTAC would meet the GIC's obligations in the Gas Act to ensure gas market participants can access the transmission pipeline on reasonable terms.



- 5.1.2 This is because we have concerns, as a small market participant operating in a concentrated industry, that both:
- a) particular features of the final design; and
  - b) the proposed mechanism for implementing a mandatory multi-party access arrangement, will
  - c) provide a weak constraint on monopoly behaviours and/or the exercise of market power by other shippers; and
  - d) produce an inferior outcome to regulated access terms where the regulator has a proactive duty to ensure the arrangements facilitate competition by:
    - i. providing suitable access terms for a party operating solely at the retail level; and
    - ii. maintaining market confidence by providing effective arrangements to ensure all parties comply with the Code and there are suitable low cost remedies to address any non-compliance.
- 5.1.3 It follows that we do not think the GIC should approve the proposed GTAC as meeting Gas Act and GPS requirements.
- 5.1.4 For any questions relating to the material in this submission, please contact me on 07 572 9888.

Regards,



**CRAIG SCHUBAUER**

**WHOLESALE MARKET MANAGER**



## Appendix A    The Lantau Group's Report

*"Assessing the GTAC: Lingering Issues"*, a report by the Lantau Group, 15 January 2018.

*[attached as a separate document]*