

18 December 2009

Hon Pansy Wong
Associate Minister of Energy and Resources
Parliament Buildings
Wellington

Dear Minister

Gas Transmission Pipeline Balancing

In October 2009 Gas Industry Co issued a Statement of Proposal on Transmission Pipeline Balancing, which proposed that rules be introduced to provide an efficient, unified balancing arrangement for managing pipeline imbalance. Gas Industry Co has now considered submissions it received on the Statement of Proposal and decided at its Board meeting on 18 December to recommend to you that the 'participative regulation' balancing rules, identified as the preferred option in the Statement of Proposal should be introduced.

Gas Industry Co has considered whether recent balancing initiatives made by the industry would cause it to reassess the need for, or scope of, these rules. We have concluded that this will not be necessary. The Board has also considered implementation and rule drafting issues. The Board has asked the executive to defer sending the Company's formal recommendation to you until it has the opportunity to discuss these items with the industry.

These matters are discussed below.

Outline of recommendation

Our recommendation that balancing rules be introduced is the conclusion of an exhaustive exploration of the issues and options with the industry over the past few years. In essence, the recommendation is to introduce rules to provide for the appointment of a single balancing agent to manage the inventory of gas in all open access transmission pipelines in a unified manner, as described in the Statement of Proposal.

The draft rules allow transmission system owners (TSOs) an opportunity to jointly develop a balancing plan in consultation with system users, within criteria set out in the rules, and appoint a balancing agent. If the TSOs cannot agree, Gas Industry Co will develop the balancing plan and appoint a balancing agent.

Scrutiny of Draft Rules

As previously mentioned, Gas Industry Co believes that there is value in allowing time for the draft rules to be considered further by the industry. The Second Options Paper contained an outline of the regulation required to implement the participative regulation option. Subsequently the Statement of Proposal contained a draft of the proposed rules. However, in submissions Gas Industry Co received very few detailed comments on the draft rules. This is a concern to Gas Industry Co and, we understand, to your officials.

Our experience on the Gas (Downstream Reconciliation) Rules 2008 was that industry attention did not focus on the rules until a recommendation had been made to the Minister that rules be put in place. Unfortunately, in that instance, this was too late. The result was that a number of rules did not recognise industry practice. This caused many avoidable breaches, with consequential costs to the industry. We wish to avoid a repeat of this experience.

Development of implementation plan

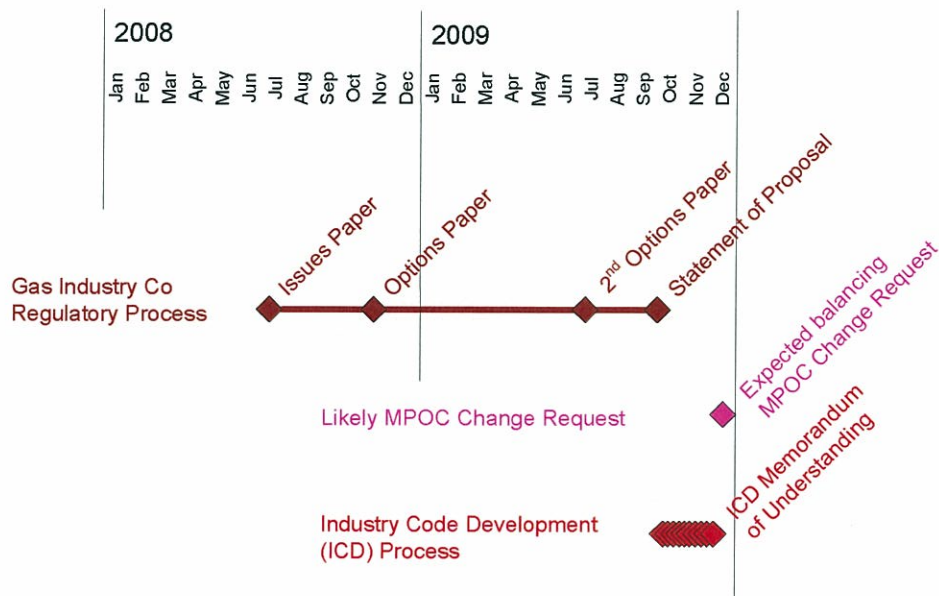
Experience also alerts us to the importance of robust and realistic implementation plans. Effective implementation of the rules will depend on the co-operation and contribution of industry participants, particularly the TSOs. It is best to do this work before the rules are Gazetted. This will ensure that the industry understands what is expected of it, and prepares the necessary resources.

Consideration of changing circumstances

Before making its decision on the preferred option, Gas Industry Co has also explored whether there are any changed circumstances since the Statement of Proposal was developed that would cause us to reassess our recommendation. Two matters in particular have been considered:

- Maui Development Limited (MDL) has advised Gas Industry Co that it is developing a set of changes to the Maui Pipeline Operating Code (MPOC) that it believes will achieve many of the improved balancing outcomes sought by Gas Industry Co, but only for the Maui pipeline; and
- a group of industry participants has developed a Memorandum of Understanding (MOU), which sets out a package of changes to the MPOC, Vector Transmission Code (VTC), and related industry arrangements that, if introduced, may avoid or minimise the need for regulatory intervention.

The timing of these late developments are illustrated below.



Likely MDL change request

At the time of writing this letter the MDL proposal has not been received. However, we have a broad understanding of what it is likely to contain. Basically it will: propose a form of back-to-back balancing to allow better targeting of balancing costs; allow for consultation on standard operating procedures relating to balancing; and include some principles on the operation of its balancing market. It may even allow access to the Rulings Panel as a dispute resolution option.

MDL's proposal will be processed once MDL submits it under the industry code change previously agreed with them. In our advice to the Board on this possible development we have assumed that the change will occur as envisaged by MDL. Our analysis concluded that this would not change our choice of the preferred regulatory solution described above.

Industry MOU

In contrast, the MOU proposal developed by the wider industry will only proceed if balancing rules are not implemented. It has been analysed on the same basis as the analysis in our Second Options Paper.

In considering the MOU proposal it is also necessary to bear in mind that it:

- is non-binding;
- is only supported by Contact Energy, Genesis Energy, Greymouth Gas (with some reservations), MDL, and New Zealand Steel.
- is still at a high level, leaving significant negotiation of the detail to be worked through; and
- does not extend the balancing regime to non-code transmission system users¹.

¹ There are a number of non-code shippers on the Vector pipelines, usually relating to shipping gas to major users such as power stations.

Also, during the ICD process we observed that, when industry participants disagree, there is no effective means of resolving the impasse. In these situations the issue is either 'parked' or 'watered down' to the point where it can be agreed. This puts MDL in an advantageous position because, when the MOU is finally translated into code changes, MDL can veto a change if, among other matters, the change would materially adversely affect its Maui Pipeline business or tariffs; or the business of an interconnected pipeline; or the compatibility of the open access regimes of MDL and an interconnected pipeline. (MPOC, section 29.4(b)) Similar concerns apply to Vector and the VTC, but to a lesser extent².

Significantly, although Vector was an active participant in developing the MOU, it found that it could not support the final document for reasons that it outlined in a letter to Gas Industry Co. A copy of that letter is attached. Essentially, 'Vector does not believe that an integrated balancing regime can be achieved in a timely or cost effective manner purely through changes to the contractual framework'.

Gas Industry Co therefore now has very little confidence that industry code changes alone will deliver the benefits of a unified balancing regime. Also, we are confident that nothing in either of these late developments will alter the substantive conclusion of the Statement of Proposal, that the preferred option is the participative regulation option.

Conclusion on changing circumstances

Gas Industry Co has tested the robustness of our recommendation against the changing circumstances described above. Essentially our analysis shows that:

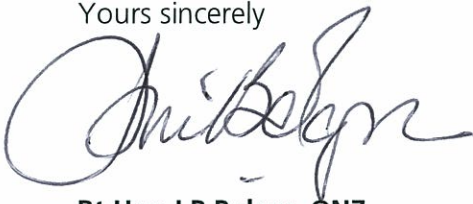
1. both the participative regulation option and the MOU proposal yield significant net benefits over and above the possible MPOC change notified by MDL; and
2. if the detail of the MOU proposal could be successfully negotiated, and implemented through code changes, it would still be inferior to the participative regulation option, particularly in relation to governance.

Conclusion

In summary, we have completed the analysis of transmission pipeline balancing and concluded that the best solution for New Zealand is the 'participative regulation' option described in the Statement of Proposal. Our Strategic Plan anticipates that we would give you a recommendation on balancing this month. However, we think it is prudent to allow the industry more time to fully engage in reviewing the draft rules and developing implementation plans. We therefore propose to send you the formal recommendation at the end of February 2010. Copies of the recommendation (without fully updated rules and implementation plans) can be made available to your officials before then, if required.

² The Vector Transmission Code change process allows decisions on code changes to be appealed to Gas Industry Co, whose recommendation is final and binding.

Yours sincerely

A handwritten signature in black ink, appearing to read 'J Bolger', written in a cursive style.

Rt Hon J B Bolger, ONZ
Chairman

Attached:

Letter to Gas Industry Co from Vector Limited regarding the Gas Transmission Balancing MOU dated 3 December 2009.

3 December 2009



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Mr Ian Wilson
Gas Industry Company Ltd
PO Box 10 646
WELLINGTON

Dear Ian

Gas Transmission Balancing MOU

This is to let you know that Vector as the pipeline owner and operator, will not be signing the Memorandum of Understanding and provide you with our reasoning behind this decision.

Vector believes the implementation of an integrated package of measures is necessary to improve balancing performance across the system. The keys to achieving an effective balancing regime are a nominations regime across the transmission system from which users who have not supplied sufficient gas to meet their demand can be identified, a co-ordinated set of Standard Operating Procedures across the system, and effective mechanisms to ensure the costs of balancing are borne by causers. At the same time, users of the system need access to tools and information to be able to self balance to the extent it is cost effective for them to do so.

With respect to the attached Memorandum of Understanding *Integrated Gas Balancing Regime* (MOU), Vector Gas Limited:

- Agrees the document reflects the progress made by the Industry Code Development (ICD) process;
- Agrees an integrated balancing regime based on a number of the matters outlined in the Schedules of the MOU is required to improve industry balancing performance;
- Agrees that all changes impacting the flow of balancing charges between parties need to occur simultaneously and preferably to be effective on 1 October 2010;
- Notes that the ICD process has to date taken ten weeks at an opportunity cost to the industry of several hundred thousand dollars;
- Notes that points of significant difference remain within the industry on key matters; and
- Does not believe an integrated balancing regime can be achieved in a timely or cost effective manner purely through changes to the contractual framework.

Vector recommends a regulated solution is pursued to:

- Achieve an integrated balancing regime in timely and cost effective manner;
- Resolve the points of significant difference in the proposed regime; and
- Compel parties to participate in the regime.

An integrated package of measures is key to an improvement in balancing performance.

The non-binding nature of the MOU and the points of significant difference in the industry, make such an integrated package an unlikely product of any continuation of the ICD process; but, importantly, an achievable outcome under a regulated solution.

Progressing with parts of the package in isolation is not an avenue Vector believes is in its, or its customers, interests. For example, the suggested MPOC Change Request to implement back-to-back cashouts would not in its own right improve balancing performance but simply shift the recovery of the costs from party to another, in this case, from Maui shippers (albeit a predominately socialised cost via the tariff) to Vector shippers. It is Vector's view that Maui shippers contribute to the imbalance, given their nominations are not linked to demand, while Vector shippers are obliged to deliver gas to consumers with limited ability to influence the nominations on the Maui pipeline, from which the imbalance is determined. Vector has not had the opportunity to assess the Change Request itself, and we make our comments based on the general description presented during the ICD process. Vector needs to ensure it protects its customer's rights, and can invoke the relevant provisions of its Interconnection Agreement (ICA) if the Change Request does not lead to favourable outcomes.

Vector also notes that the substantial costs (including the costs of resolving the points of significant difference) associated with a protracted and/or only partially concluded ICD process should be recognised in any assessment undertaken by the Gas Industry Company.

In line with the above comments, Vector looks forward to working with the industry and Gas Industry Company to implement an integrated package of measures to improve balancing performance across the system.

Yours faithfully



Daniel McCarthy
Group General Manager Commercial
Vector Limited