# Draft Recommendation: 14 December 2011 VTC Change Request Appeal

**Date issued: 4 May 2012**
**Submissions close: 28 May 2012**

GAS INDUSTRY COMPANY LIMITED

## About Gas Industry Co.

Gas Industry Co is the gas industry body and co-regulator under the Gas Act. Its role is to:

- develop arrangements, including regulations where appropriate, which improve:
  - the operation of gas markets;
  - access to infrastructure; and
  - consumer outcomes;
- develop these arrangements with the principal objective to ensure that gas is delivered to existing and new customers in a safe, efficient, reliable, fair and environmentally sustainable manner; and
- oversee compliance with, and review such arrangements.

Gas Industry Co is required to have regard to the Government's policy objectives for the gas sector, and to report on the achievement of those objectives and on the state of the New Zealand gas industry.

Gas Industry Co's corporate strategy is to 'optimise the contribution of gas to New Zealand'.

# Executive summary

Vector Limited (Vector) proposed a change to the Vector Transmission Code (VTC) on 16 November 2011 that did not receive the 75 percent support from Shippers necessary for it to be adopted. Vector appealed to Gas Industry Co, in its Vector Transmission Code (VTC) appeals body role, to have the change request allowed (pursuant to section 25.6 of the VTC).

The proposed change aims to alter VTC arrangements in respect of peaking, corrections, prudential requirements, Shipper insolvency, and invoicing. Gas Industry Co's role is to recommend whether the change should be supported. It does this by analysing whether the changed arrangements would better meet the objectives of the Gas Act and Government Policy Statement (GPS) than current arrangements. Our analysis indicates that the proposal would bring improvements in relation to corrections and invoicing; be neutral in respect of prudential requirements; and be detrimental in respect of peaking and shipper insolvency.

Gas Industry Co is required to make a single recommendation on the proposed change, and cannot separate or otherwise materially change it. The scope of the proposed change has made it difficult for Gas Industry Co to arrive at an overall view. However, our concerns in relation to peaking and shipper insolvency are sufficiently significant for us to conclude that it is prudent not to support the proposal. The changes proposed in both areas seem to move against achieving Gas Act objectives, and be likely to reduce efficiency by removing an option to target costs and allocating risk to parties least able to manage the risk.

## Draft Recommendation

Gas Industry Co's draft recommendation does not support the change request.

## Next Steps

Gas Industry Co invites submissions on this Draft Recommendation.

Submissions are due by 5pm, 28 May 2012. Please note submissions received after this date may not be considered.

# Contents

# 1 Introduction

## 1.1 Purpose

This paper presents an analysis of, and draft recommendation on, the Vector Transmission Code (VTC) Change Request Appeal submitted by Vector Limited (Vector) on 14 December 2011 (the appeal).

The appeal and other relevant papers can be found at http://gasindustry.co.nz/work-programme/vtc-change-request-appeal-14-december-2011-invoicing. A glossary at the end of this document explains abbreviations and key terms.

## 1.2 Background

### Gas Industry Co's role under the VTC

Under the VTC, any party can request a variation or modification to, or waiver from, any provision of the VTC. Section 25 of the VTC sets out a process for considering such change requests, which includes compulsory consultation with all shippers on Vector's transmission system. Under section 25.5(c)(i) of the VTC, Vector and 75 percent of all shippers who respond must consent to a change request for the change to be made to the VTC. Once that process is complete, certain parties may appeal the outcome whether or not the change request was successful. For example, a party who voted against a change request that was successful may appeal that outcome and vice versa.

Gas Industry Co is tasked with independently reviewing and making a recommendation on change request appeals. Following consultation, Gas Industry Co must make a final recommendation 'supporting or not supporting the Change Request or finding that Vector has or has not validly withheld consent'[1].

In consultation with its Shippers, Vector developed a process for considering change request appeals under the VTC. Gas Industry Co and Vector have incorporated that process into a Memorandum of Understanding (MoU). The MoU sets out in detail the process that Gas Industry Co follows when considering appeals. A copy of that MoU is available on Gas Industry Co's website: http://gasindustry.co.nz/sites/default/files/publications/Memorandum_of_Understanding_with_Vector.pdf

[1] VTC Section 25.7.

When making its recommendation on an appeal, the MoU requires Gas Industry Co to have regard to the objectives specified in section 43ZN of the Gas Act 1992 (the Gas Act) and the objectives specified in the Government Policy Statement on Gas Governance (GPS). The combined principal objectives for Gas Industry Co are to ensure that gas is delivered to existing and new customers in a safe, efficient, fair, reliable, and environmentally sustainable manner.

Gas Industry Co's final recommendation is binding on the parties to the VTC, but not if Vector has withheld its consent and the change would result in Vector incurring capital expenditure or operating expenses[2]. Even then, if another party is prepared to cover the cost, or Gas Industry Co regulates to recover the cost, then Vector is obliged to make the change.

## Current appeal

On 14 December 2011, Gas Industry Co received an appeal from Vector. The appeal relates to a change request initiated by Vector and notified to shippers by Vector on 16 November 2011 titled 'VTC Change Request: Invoicing'.

Of the seven shippers who responded to the change request, one consented and six did not. Clause 25.5(c) of the VTC requires the consent of Vector and 75 percent of all shippers who respond to a change request before the change can be made. This threshold was not met and Vector appealed to Gas Industry Co to seek its support to have the change allowed.

On 21 December 2011 Gas Industry Co requested some additional information from Vector to assist our processing of the Change Request Appeal. This information was provided on 27 January 2012 and on 3 February we posted all the relevant documents on our website and called for submissions on the appeal.

Submissions on the appeal closed on 22 March 2012. Submissions were received from:

- Genesis Energy;
- Mighty River Power (MRP); and
- Nova Energy.

In this Draft Recommendation we analyse the appeal, including the additional information provided by Vector and submissions on the appeal.

## MRP change request

On 27 January 2012, MRP lodged a VTC change request that is substantially the same as Vector's change request except for the exclusion of changes related to Shipper (retailer) insolvency, peaking and disputed invoices. The MRP change request was

[2] VTC section 25.5(b)(i) and (ii).

consented to by six shippers, but Vector refrained from voting pending Gas Industry Co's ruling on this appeal. We understand that not all Shippers consider that Vector is able to suspend the progress of the MRP change request in this way.

However, these are matters for Vector and its Shippers to deal with in the first instance. The analysis in this Draft Recommendation relates solely to consideration of the appeal, which is Gas Industry Co's contractual role under the VTC. Accordingly we do not offer any view on the MRP change request process in this Draft Recommendation, or on the relative merits of the two change requests.

## 1.3 Overview of changes

The appeal contains a number of proposed changes to the VTC, with the general theme being related to 'invoicing'. Many proposed changes are responses to two events: the liquidation of E-Gas in 2010 and a self-reported breach of the Downstream Reconciliation Rules by Contact Energy. In its appeal to Gas Industry Co, Vector outlined the reasons it was making the appeal, including that the proposal will:

- as a whole be beneficial to Shippers and the industry;
- reduce Vector and Shipper dispute resolution costs by encouraging better dispute resolution practices;
- assist Shippers in minimising their balancing costs by making them aware of changes to their Running Mismatch position prior to those changes taking effect; and
- ensure that, when a Shipper becomes insolvent, the cost of balancing gas will be properly allocated to other Shippers and Vector.

## 1.4 Structuring the appeal for evaluation

Although the initial change request was titled 'Invoicing Change Request', Gas Industry Co finds that the analysis is simpler if the change is separated into its broad components. There are five general components to the change request:

- peaking;
- corrections;
- prudential requirements;
- Shipper insolvency: unpaid fees; and
- invoicing.

### Peaking

Vector proposes amending section 8.13—Allocation of payments into and out of the BPP Pool—to allow it to share any peaking charges it receives from MDL across all Vector Shippers on a pipeline (other than any Shipper which has demonstrated to Vector's reasonable satisfaction that it did not cause or contribute to Vector incurring the peaking cost),, rather that determining which particular Shippers contributed to the peak. Vector considers this change reflects current practice and is necessary because delivered quantities are not generally determined on an hourly basis, so Vector does not have the ability to determine whether or not a Shipper caused or contributed to a Peaking Limit being exceeded at a TPWP.

### Corrections

Vector proposes amending section 8.21—Corrections—to give effect to requests from Shippers that corrected delivery quantities become effective in the following month instead of the current month as at present..

### Prudential requirements

Vector proposes amending section 14—Prudential Requirements—to require that prudential arrangements extend 30 months after the termination of a Shipper's TSA, and allow that Vector does not need to hold cash bonds.

### Shipper insolvency: unpaid fees

Vector proposes introducing a new section 8.36—Allocation of BPP Amounts on Insolvency Events—to allow it to recover any unpaid balancing charges attributable to an insolvent Shipper from all Shippers and Non-Code Shippers.

### Invoicing

Vector proposes adding a section 6.7—Finality of Allocation Results and Delivery Quantities—and changing sections 16.17—Disputed Invoices—and 16.20—Overcharges and Undercharges—in order to encourage prompt payment of invoices and better dispute practices, and to extend the period for re-opening Transmission invoices where there has been a special allocation.

Table 1 below sets out Vector's view of effect/purpose of the proposal.

**Table 1. Structure of the change request for evaluation**

| Component | VTC sections affected by proposal | Vector's view of effect/purpose of the proposal |
|---|---|---|
| **Peaking** | 8.13 (Balancing and Peaking – Allocation of payments into and out of the BPP Pool) | This change gives effect to what Vector must do in practice as, at present, Vector does not have the ability to determine on an hourly basis whether or not a Shipper caused or contributed to a Peaking Limit being exceeded at a TP Welded Point. Vector has found that it must allocate peaking charges to all Shippers at the Welded Point for which a Peaking Limit has been exceeded. |

| Component | VTC sections affected by proposal | Vector's view of effect/purpose of the proposal |
|---|---|---|
| **Corrections** | 8.21 (Balancing and Peaking – Corrections) | This change gives effect to requests from Shippers that new Delivery Quantities (following interim, final, special allocations and metering corrections) become effective after they are notified. This will give Shippers more visibility of any changes to their Delivery Quantities so that they will be able to calculate the effect on their mismatch before the changes in mismatch positions become effective. This could assist Shippers in managing their exposure to balancing costs. |
| **Prudential requirements** | 14 (Prudential Requirements) | Proposed changes are necessary clarifications identified by Vector after the liquidation of E-Gas and a self-reported breach of the Gas (Downstream Reconciliation) Rules 2008 by Contact Energy. |
| **Shipper insolvency: unpaid fees** | 8.36 (Balancing and Peaking – Allocation of Balancing and Peaking Pool amounts on insolvency events) | Intended to properly allocate responsibility for BPP charges in the event of Shipper insolvency. |
| **Invoicing** | 6.7 (Determination of Gas Quantities – Finality of allocation results and delivery quantities) | Introduced to give greater clarity. |
| | 16.17 (Invoicing and Payment – Disputed Invoices) | Adjusted process for disputed invoices to encourage prompt payment of invoices and better dispute practices. |
| | 16.20 (Invoicing and Payment – Overcharges and Undercharges) | To extend the period for re-opening Transmission Charges invoices where there has been a special allocation. |

## 1.5 Gas Industry Co's request for further information

Shortly after Vector advised Gas Industry Co of its appeal, Gas Industry Co wrote to Vector requesting further information in order to assist Gas Industry Co's processing of the appeal. A copy of the request for further information and Vector's response to it were made available on Gas Industry Co's website once Vector's response was received.

Table 2 summarises Gas Industry Co's request for additional information and Vector's response. The full documents can be found at http://gasindustry.co.nz/work-programme/vtc-change-request-appeal-14-december-2011-invoicing .

**Table 2. Gas Industry Co's request for further information to Vector and Vector's response**

| Issue | Gas Industry Co's question | Vector's response |
|---|---|---|
| **Peaking** | What is the frequency and | • In its role as a Welded Party under the |

| Issue | Gas Industry Co's question | Vector's response |
|---|---|---|
| | magnitude of peaking charges over the last few years? Do you consider that this is a good indication of possible future peaking charges? | MPOC, Vector has been invoiced for 28 different peaking events totalling close to half a million dollars since January 2009. Peaking events are generally more common during the winter but can and do occur year round.<br>• While the balancing and peaking regime remains the same, Vector has no reason to believe that Shippers or MDL's actions which cause Vector to incur peaking costs will change.<br>• The GIC is currently considering the MPOC Change Request of 13 October 2011. We noted in our submission to the GIC on that Change Request that 'it increases Vector's exposure to peaking costs. Based on 2010 and 2011 data, peaking costs could increase seven fold based on the existing level.' |
| | Can you explain specifically why Vector has not been able to apply the current peaking provisions of the VTC? It appears that the current arrangements involve making an effort to identify the parties responsible for peaking, whereas the proposed change involves spreading the costs of peaking across all users. Can Vector provide some examples to help us understand why this change is desirable? | • Peaking at a Welded Point can only occur if the average 3 hourly flow through the relevant Welded Point exceeds the Peaking Limit. The Peaking Limit is calculated with reference to the Hourly Scheduled Quantity at the relevant Welded Point.<br>• For example, at the combined Welded Points (Rotowaro, Pokuru and Pirongia), Vector can only incur a peaking cost when:<br>*The average metered quantity at the combined points over a 3 hour period is greater than the greater of (125% of the Hourly Scheduled Quantity at the combined points and 10,000GJ)*<br>• When Vector attempts to determine whether one or more specific Shippers have caused or contributed to Vector incurring a peaking cost, Vector considers the difference between Shippers average 3 hourly Delivery Quantities and hourly Receipt Quantities at the relevant Welded Point.<br>• For example at the combined Welded Points (Rotowaro, Pokuru and Pirongia), Vector considers whether:<br>*A Shippers average Delivery Quantity over a 3 hour period at the combined points is greater than 125% of that Shippers hourly Receipt Quantity at the combined points*<br>• In practice:<br>a. Vector is unable to determine |

| Issue | Gas Industry Co's question | Vector's response |
|---|---|---|
| | | Shippers' hourly Delivery Quantities at a Welded Point because the Allocation Agent, under the Downstream Reconciliation Rules, does not determine allocated quantities on an hourly basis; and<br>b. where Delivery Quantities are determined on an hourly basis via TOU metering, Vector is unable to determine a Shippers corresponding hourly Receipt Quantity at the relevant Welded Point. Shippers generally make nominations to a Welded Point to cover all of their expected demand downstream of the Welded Point. Nominations are not typically linked to a single end user or site.<br>• Therefore due to inherent data limitations Vector is unable to identify which Shipper(s) have caused or contributed to Vector incurring a peaking cost.<br>• Vector allocates peaking costs to Shippers under the current VTC section 8.13 (b) (iii).The proposed change seeks to reflect Vector's current practice. |
| **Prudential requirements** | What is Vector's rationale for increasing the amount payable by Shippers to Vector or the BPP Trustee from $100,000 to $115,000? | • This change is proposed to clarify the intent of the VTC by explicitly stating that any cash bond or security bond amount provided by a Shipper is GST inclusive. It does not represent any increase in Vector's prudential requirements.<br>• Section 16.6 of the VTC states 'All amounts payable under a TSA are stated before the calculation of GST, which shall be due and payable at the same time as the payment to which it relates is due (GST Amount).' Each prudential amount requested from a Shipper is GST inclusive and we understand that Vector's reliance on 16.6 has caused confusion for some Shippers. |

| Issue | Gas Industry Co's question | Vector's response |
|---|---|---|
| | What is the rationale for deleting section 14.8 (accrual of interest)? | • Vector has removed the option for Shippers to provide a cash bond to satisfy its prudential requirements under the VTC. This option has not been utilised by Shippers, is administratively heavy and may be subject to claw back under the Companies Act. As a consequence of this, under the VTC Vector will not hold any interest accruing cash bonds on behalf of its Shippers. |
| | Does Vector have business continuity insurance or some other form of insurance that mitigates the need for this prudential cover? | • Business continuity insurance generally covers the loss of income as a result of a disaster while necessary repairs are made to gas production stations or pipelines (for example). Business continuity insurance would not cover the risk of Shippers defaulting on their transmission or BPP payment obligations.<br>• Vector considers that requiring prudential amounts from its Shippers is a commercially sound approach to managing credit risk. Incurring cost to insure against the potential loss of revenue from a party defaulting on its VTC payment obligations would be a less commercially sound approach. |
| **Shipper insolvency: unpaid fees** | What is Vector's rationale for inserting new clause 8.36? Does Vector have insurance cover for this type of risk at present? | • Under the MPOC, Vector incurs balancing costs in its role as a Welded Party. These balancing costs are on account of Shippers' use of the transmission system. Therefore Shippers collectively are responsible for the balancing costs. Vector recovers these balancing costs on behalf of MDL, and being a regulated business it is limited in its ability, unlike competitive businesses, to simply increase its prices to recover any unrecovered balancing costs. Although Vector has prudential arrangements in place with all of its Shippers and actively monitors these on a regular basis, these are not effective in all situations. Other options must be utilised to ensure that balancing costs are recovered on behalf of MDL.<br>• Vector does not have insurance to cover this risk. Due to the pass through nature of the balancing obligations, Vector would be unable to recover the cost of this insurance. |

| Issue | Gas Industry Co's question | Vector's response |
|---|---|---|
| | What impact (if any) does the Commerce Commission's proposed Input Methodologies have on the proposed clause 8.36? | • The Commerce Commission published its 'Commerce Act (Gas Transmission Services Input Methodologies) Determination 2010' in December 2010.<br>• Vector considers that the Input Methodology does not have any impact on the proposed section 8.36. |
| **Invoicing** | What is Vector's rationale for changing the process for disputed invoices and specifically the inclusion of (new) clause 16.17(b)? | • Vector considers that the changes to the disputed invoices process will encourage prompt payment of invoices and better dispute practices by:<br>a. Encouraging Shippers to actively engage in the dispute resolution process; and<br>b. Encouraging only genuine issues be disputed |

# 2 Evaluation criteria

As noted in section 1.2 above, Gas Industry Co will have regard to the objectives of section 43ZN of the Gas Act and the GPS when making its recommendation on a VTC appeal.

## Objectives in section 43ZN of the Gas Act

The principal objective of Gas Industry Co in developing/recommending any regulation is to:

…ensure that gas is delivered to existing and new customers in a safe, efficient, and reliable manner.

The other objectives are:

- the facilitation and promotion of the ongoing supply of gas to meet New Zealand's energy needs, by providing access to essential infrastructure and competitive market arrangements; and
- barriers to competition in the gas industry are minimised;
- incentives for investment in gas processing facilities, transmission, and distribution are maintained or enhanced;
- delivered gas costs and prices are subject to sustained downward pressure;
- risks relating to security of supply, including transport arrangements, are properly and efficiently managed by all parties; and
- consistency with the Government's gas safety regime is maintained.

## GPS objectives and outcomes

### Objectives

The GPS requires Gas Industry Co to have regard to two further principal objectives—fairness and environmental sustainability—in all of its recommendations.

Gas Industry Co must also have regard to the other objectives set out in the GPS as follows:

- energy and other resources used to deliver gas to end users are used efficiently;

- competition is facilitated in upstream and downstream gas markets by minimising barriers to access to essential infrastructure to the long-term benefit of end users;
- the full costs of producing and transporting gas are signalled to end users;
- the quality of gas services where those services include a trade-off between quality and price, as far as possible, reflect customers' preferences; and
- the gas sector contributes to achieving the Government's climate change objectives as set out in the New Zealand Energy Strategy, or any other document the Minister of Energy and Resources may specify from time to time, by minimising gas losses and promoting demand-side management and energy efficiency.

## Outcomes

The GPS sets out specific outcomes Gas Industry Co is expected to pursue through its work programme. The outcomes relevant to gas quality cover those for an efficient retail market, and access to key infrastructure.

Outcomes for an efficient retail market are:

- an efficient market structure for the provision of gas metering, pipeline, and energy services; and
- a clear understanding of the respective roles of gas metering, pipeline, and gas retail participants.

Outcomes for access to key infrastructure are:

- gas industry participants and new entrants are able to access ….distribution pipelines…. on reasonable terms and conditions; and
- consistent standards and protocols apply to the operations relating to access to all distribution pipelines.

# 3 Evaluation of the proposal

## 3.1 Peaking

### Current arrangements and proposed change

Currently section 8.13(b) of the VTC provides that if a Peaking Limit is exceeded, resulting in fees being paid to the MDL Incentives Pool Trustee, Vector may recover this cost. Where Vector is able to identify who caused the cost, Vector can recover the cost from those parties in proportion to their contribution to the peak. Or, if Vector is not able to identify who to allocate the cost to, the cost will be shared among all possible contributors (Shippers and Non-Code Shippers on the relevant Pipeline) in proportion to their deliveries on the day the cost was incurred. The possible contributors will not include any Shipper who has demonstrated to Vector's reasonable satisfaction that it did not cause or contribute to Vector incurring the peaking cost.

The proposal is that Vector should no longer have the option of identifying at the outset which of its shippers contributed to a peak, and recovering peaking costs from them. Instead, it will always recover peaking costs from all shippers (on the relevant pipeline) in proportion to their deliveries on the day the costs were incurred, but excluding any Shipper on the relevant pipeline who has demonstrated to Vector's reasonable satisfaction that it did not cause or contribute to Vector incurring the peaking cost.

### Evaluation

We consider that the objectives most relevant to a consideration of proposed change are the Gas Act provisions that 'risks relating to security of supply, including transport arrangements, are properly and efficiently managed by all parties' and 'delivered gas costs and prices are subject to sustained downward pressure', and the GPS objective that 'the full costs of producing and transporting gas are signalled to end users'.

To help assess the scale of the issue, Gas Industry Co asked Vector for further information on the size and frequency of peaking costs. From Vector's response (see Table 2), it is possible that peaking costs could increase over past levels by a factor of seven. Since Vector estimated peaking charges for a three year period from January 2009 to be 'close to half a million dollars' over '28 different peaking events', this suggests Vector expects that peaking charges could increase to about \$1m/year (7 × \$0.5m / 3), over 65 events/year (7 × 28 events / 3).

The intention of the peaking charge is to discourage Maui Pipeline Welded Parties from peaking. Although Vector is a TPWP, it is Vector's Shippers who are most likely[3] to cause peaking at Vector Welded Points, thereby attracting peaking charges. If Vector (as a TPWP) shares the peaking cost across all Shippers (on the relevant pipeline) irrespective of their respective contributions to the peak, the effectiveness of the peaking charge will be substantially diminished. Effectively, this will blunt any incentive MDL may apply to discourage peaking at Vector Welded Points.

Several questions arise from this. First, we must consider whether discouraging peaking is likely to assist in ensuring that risks relating to security of supply are properly and efficiently managed by all parties. If so, we must investigate whether the proposed change—to a more tolerant stance in relation to peaking—is justified. Also relevant are considerations of whether the proposal is more likely to put downward pressure on delivered gas costs, and signal the full costs of producing and transporting gas.

We consider that discouraging peaking is a proper element of pipeline management and promotes security of supply for the following reasons:

- Overseas regimes commonly require Shippers to manage their hourly quantities in some fashion. Pipelines typically require intra-day gas flow nominations[4] and offer a range of intra-day services for users who have intra-day peak usage requirements[5]. This suggests that managing intra-day peaks is an integral aspect of effective pipeline management.
- MDL believes the management of intra-day peaks is important. At forums and in submissions MDL and individual Maui Joint Venture partners have expressed concerns that intra-day peaking may require corrective balancing actions and in an extreme situation increase the risk of interruption. Their concern appears to centre on the increasing peakiness of gas fired power generation, rather than the reticulated market. We note that over half of the demand on Vector's pipeline supplying Auckland is for gas fired power generation.
- Vector considers that significantly uneven flow profiles can detrimentally impact on its ability to provide capacity to its customers. In particular, in the VTC:
  - Maximum Hourly Quantity (MHQ) is limited by definition to 1/16$^{th}$ of the Maximum Daily Quantity (MDQ), unless otherwise agreed;
  - Section 2.2 describes transmission rights both in terms of MDQ and MHQ, suggesting that the management of hourly quantities is an important feature; and

[3] Where Vector controls compressors at a TPWP it could cause a Peaking Limit to be exceeded through efforts to manage its linepack, but instances of this are likely to be rare.
[4] For example, in the US Gas Industry Standards Board (GISB) encourages the use of intra-day nominations as a gas supply management tool.
[5] For example by offering 'Upstream Pipeline Balancing Service' to Shippers who purchase gas on a ratable (even) basis through the day but wish to deliver it on a non-ratable basis, and 'Downstream Pipeline Balancing Service' to Shippers who have short notice delivery requirements.

- Section 10.1(b) of the VTC provides that exceeding MHQ can be grounds for Vector to curtail or manage a Shipper's receipts and/or deliveries;

On the basis that the management of intra-day peaks appears to be important for pipeline management, we can consider whether the proposed change is an improvement on current arrangements.

Vector believes the proposed change is justified because '…Delivery Quantities are not generally determined on an hourly basis, Vector does not have the ability to determine whether or not a Shipper caused or contributed to a Peaking Limit being exceeded at a TP Welded Point. Therefore, as a matter of practice, Vector has found that it needs to allocate peaking charges to all Shippers at the relevant Welded Point, and the procedures in sections 8.13(b)(i) and (ii) are redundant.' (16 November 2011 Change Request). In response to Gas Industry Co's request for further explanation, Vector noted that

> In practice:
>
> a. Vector is unable to determine Shippers' hourly Delivery Quantities at a Welded Point because the Allocation Agent, under the Downstream Reconciliation Rules, does not determine allocated quantities on an hourly basis; and
>
> b. where Delivery Quantities are determined on an hourly basis via TOU metering, Vector is unable to determine a Shippers corresponding hourly Receipt Quantity at the relevant Welded Point. Shippers generally make nominations to a Welded Point to cover all of their expected demand downstream of the Welded Point. Nominations are not typically linked to a single end user or site.

Accordingly, Vector does not argue that management of Shipper peaks is unimportant, only that it is difficult to determine individual Shipper contributions to a peak. However, the current arrangements do not strictly require Vector to do this. Section 8.13(b) only requires that Shippers pay Vector part of the cost Vector has been allocated where Vector '…acting reasonably, determines such cost is on account of Gas delivered to…' that Shipper.

We agree that the information currently available to Vector is not sufficient to implement a truly back-to-back pass through of peaking costs. MDL's Peaking Limit is usually 125% of the Welded Point Hourly Scheduled Quantity (HSQ). Unless otherwise agreed between MDL and the relevant Welded Party, the HSQ is the amount that would need to be taken at a Welded Point in each remaining hour of the day in order to match the Scheduled Quantity (SQ). (Expressed as a formula HSQ=SQ (at the beginning of the hour), less the amount taken in the previous hours of the day, all divided by the number of remaining hours of the day.)

An SQ represents the sum of the individual nominations made by each Maui shipper at a Welded Point. At TPWPs, Maui Shippers will have made these nominations on the basis of what Vector Shippers expect to deliver. However, these amounts are not known to Vector. Vector's standard service is a 'no-notice' service, meaning that a

Vector Shipper is not required to make nominations to Vector. Rather, it can take any quantity of gas up to its reserved capacity. The only information Vector has for a Shipper on its standard service is the amount of capacity that Shipper has reserved. It has no knowledge of how much of that capacity the Shipper expects to use each day.

We therefore agree that Vector does not currently have the information necessary to apply a strict back-to-back allocation of balancing costs. However, deleting the provision that gives Vector the ability to allocate peaking charges appears to be heading in the wrong direction, including frustrating MDL's efforts to manage intra-day peaking.

Furthermore, we are not convinced sharing peaking costs rather than making some effort to target them towards peaking users will serve to put downward pressure on delivered gas costs.

We also doubt that the proposed change will result in better signalling of the full costs of producing and transporting gas. We believe that targeting costs to causers is the best means of signalling cost. The socialisation of costs only serves to obscure costs.

While Gas Industry Co's VTC appeals role does not involve the consideration of alternative options, we note that there must be alternatives open to Vector which would assist in achieving the Gas Act objective and avoid thwarting MDL's parallel efforts to similarly better manage peaking behaviour. It is regrettable that the two TSOs, who must work together closely to manage gas flows, cannot assist each other in this basic aspect of good pipeline housekeeping.

Gas Industry Co concludes that:

- the indicated value (possibly $1m/year) and frequency (possibly 65 events/year) of peaking costs being allocated to Vector is significant;
- intra-day peaking is an important issue for pipeline management generally, as it also appears to be for MDL and Vector; therefore
- although Vector currently does not have the information it needs to use these provisions, the proposed change would remove Vector's ability to channel peaking costs to causers, and therefore it does not appear to further the Gas Act objective of ensuring that risks relating to security of supply, including transport arrangements, are properly and efficiently managed by all parties; also
- removing the initial ability to target costs seems likely to result in less downward pressure on costs and less effective signalling of costs to end users.

Although beyond the scope of our evaluation, we also note that there must be alternatives open to Vector which would assist in achieving the Gas Act objective.

## 3.2 Corrections

### Current arrangements and proposed change

Section 8.21 of the VTC currently provides that Vector will not change any BPP allocations of gas or cost if the numbers the calculations are based on prove to be incorrect. However, it will make corrections to Shipper receipt and/or delivery quantities, and Vector's imbalance.

The proposal is that, when Vector becomes aware of an error, it will notify this on OATIS and in the following month correct Shipper receipt, delivery and mismatch quantities and Vector's imbalance. It will then recalculate the Shipper running mismatch positions and Vector running imbalance positions on all affected days, and post a correction report on OATIS. BPP allocations will be corrected where the information being corrected originated from MDL; otherwise BPP allocations are not corrected.

The effect of the proposal is quite difficult to grasp, but Table 3 may help clarify it.

**Table 3 Corrections when incorrect information is found**

| Item | Under current arrangements | Under proposal |
|---|---|---|
| **Where information, other than Maui supplied information, is found to be incorrect** | | |
| Shipper receipts and deliveries | Corrected | Corrected |
| Shipper mismatch | Corrected | Corrected |
| Vector Imbalance[6] | Corrected | Corrected |
| Shipper running mismatch | Corrected | Corrected |
| Vector running mismatch | Corrected | Corrected |
| BPP amounts paid or payable | Vector is not required to correct | Not corrected |
| **Where Maui supplied information is found to be incorrect** | | |
| Shipper receipts and deliveries | Corrected | Corrected where appropriate |
| Shipper mismatch | Corrected | Corrected where appropriate |
| Vector Imbalance | Corrected | Corrected where appropriate |
| Shipper running mismatch | Corrected | Corrected |
| Vector running mismatch | Corrected | Corrected |

[6] Note that Vector Imbalance is a defined term in the VTC, and is not the same as the imbalance Vector may have as a Transmission Pipeline Welded Party under the MPOC. Essentially the VTC defines Vector Imbalance as the sum of: fuel and venting gas mismatches, inter-pipeline flows, and UFG.

| Item | Under current arrangements | Under proposal |
|---|---|---|
| BPP amounts paid or payable | Vector is not required to correct and will do so only if it receives a new invoice for balancing costs from MDL | Corrected |

### Evaluation

We consider that the objective most relevant to a consideration of proposed change is the Gas Act provision that 'risks relating to security of supply, including transport arrangements, are properly and efficiently managed by all parties'.

In Vector's 16 November 2011 Change Request proposal, it noted in relation to the proposed changes to section 8.21 that: 'Shippers have advised that this will assist them with managing their mismatch position and therefore reduce their exposure to balancing costs'.

We find that the proposal does appear to allow improved scope for error correction. From Vector, we understand that the the costs of this enhancement are not significant, and the proposal would therefore improve the management of risk, and efficiency more generally.

## 3.3 Prudential requirements

### Current arrangements and proposed change

The VTC currently specifies prudential requirements (section 14). Shippers must comply with these during the term of their transmission services agreements (TSA).

The proposal:

- extends the period over which prudential requirements must be met until the Shipper has paid all outstanding amounts or amounts that may become payable in the 30 months after expiry of its TSA (section 14.2);
- removes the currently available option for a Shipper to meet prudential requirements by paying two separate cash bonds, one to Vector and another to the BPP Trustee (section 14.2);
- makes the amount of security payable by Shippers to the BPP Trustee GST inclusive (section 14.5);
- notes that security payable by Shippers to Vector is GST inclusive (section 14.5);
- removes the obligation on Vector and the BPP Trustee to hold cash bonds in separate, interest bearing trust accounts; and
- clarifies what amounts are to be released from security when a TSA is terminated (section 14.11).

### Evaluation

We consider that the objectives most relevant to a consideration of the proposed change is the Gas Act provisions that 'barriers to competition in the gas industry are minimised' and 'risks relating to security of supply, including transport arrangements, are properly and efficiently managed by all parties', and the GPS objective that 'competition is facilitated in upstream and downstream gas markets by minimising barriers to access to essential infrastructure to the long-term benefit of end users'.

In applying these criteria to prudential requirements, the main concern is that the requirements reasonably reflect the risks, and are not so limited or severe that they present an unreasonable or unjustified barrier to the entry of new Shippers.

In relation to the range of prudential requirements, we do not find that the proposal significantly changes the status quo. However, we assume that it seeks to address the concerns that Vector indicated had arisen from its review of the recent retailer insolvency. Vector has decided that it does not wish to hold cash bonds and so proposes to remove the option of paying bonds directly to it. However, Shippers still have the option of arranging for a third party with an acceptable credit rating to provide a security bond to Vector. We do not believe that this would be more onerous on Shippers.

In relation to the level of prudential requirements, we note that the proposed change in the amount that may become payable to the BPP Trustee, from $100,000 to $115,000, does not reflect an increase; it simply clarifies that the amount is now GST inclusive more explicitly than the current VTC wording.

Other changes to section 14 are consequential clarifications.

We find that the proposed change does generally clarify the prudential requirements and raises no concerns of increased barriers to entry.

## 3.4 Shipper insolvency: unpaid fees

### Current arrangements and proposed change

The VTC does not currently deal explicitly with the consequences of a Shipper on Non-Code Shipper insolvency.

The proposal explicitly sets out how any BPP costs that may be allocated to Vector as a result of a Shipper or Non-Code Shipper insolvency will be handled (new section 8.36). Basically, any such costs will be recovered from all the remaining Shippers and Non-Code Shippers in proportion to their delivery volumes on the relevant pipeline. Vector is required to take reasonable steps to recover the costs from the insolvent shipper and any costs recovered will be dispersed in the same pro-rata shares.

### Evaluation

We consider that the objectives most relevant to a consideration of the proposed change are the Gas Act provisions that 'risks relating to security of supply, including transport arrangements, are properly and efficiently managed by all parties' and 'delivered gas costs and prices are subject to sustained downward pressure'.

Vector believes that the proposed changes will properly allocate responsibility for BPP charges in the event of Shipper insolvency. However, we understand that a fundamental tenet of risk management is that any risk should be allocated to the party best able to manage it and there are issues associated with Vector allocating new liabilities to Shippers. Following this principle should lead to the lowest cost outcome since the party best able to manage a risk will be incentivised to do so and has the means of doing so.

It appears to us that Vector Shippers are less able than Vector to manage the risks and other issues arising from a Retailer insolvency than Vector because, as Nova Energy points out in its submission:

- it is Vector that will have the contractual relationship with the defaulting Shipper, giving it rights in relation to invoicing, payment, dispute resolution, and prudential supervision;
- there is no contractual nexus between Shippers that would allow one or more of them to pursue a defaulting Shipper; and
- there is no way for Shippers to exercise control over each other's default risk.

A monopoly service provider such as Vector does have an incentive (and often the ability) to avoid risk by passing responsibility on to others. In some circumstances this may be efficient but for the reasons discussed above we do not think it is likely to be efficient in this situation. We are therefore sympathetic to the view expressed by Genesis in its submission that '…Vector is the party best able to manage the risk of insolvency through their existing prudential requirements'. It is also open to Vector to trigger insolvency proceedings in its capacity as a creditor when a retailer defaults and, thereby, stem the losses – that is not an option available to Vector's Shippers.

In response to our request for additional information on this matter (Table 2), Vector observes that it collects balancing costs on behalf of MDL, and that it cannot increase its prices to recover balancing costs that Vector Shippers do not pay. Vector does not believe that prudential requirements are an effective way of dealing with unpaid balancing costs. Although Vector does not say why this is, we assume it is due to a number of factors such as the difficulty in forecasting balancing costs, the fact that credit ratings may not provide adequate security in all situations, and the inherent time delays with a Shipper getting into financial difficulty and becoming insolvent..

We acknowledge that balancing costs (substantially) arise through mismatches of Vector Shippers, and that these are not controlled by Vector. However, while each individual Shipper is responsible for its own mismatch, we cannot see why it would be efficient to make it responsible for unpaid amounts arising from the mismatch of another Shipper over whom it has no control or ability to hold security.

The VTC provides prudential requirements that are intended to cover situations where Vector incurs costs as a result of a Shipper's actions, or where that Shipper has not paid amounts due. This includes the optional provision of security bonds to the BPP Trustee. If this security bond is not sufficient to cover the risk from a Shipper becoming insolvent and leaving unpaid BPP debts, the prudential arrangements should be adjusted. We do not consider that there is good reason for other Shippers to carry this risk, just as we would not expect them to carry the risk that another Shipper defaults on other payments due to Vector.

In conclusion we find that the proposal will not result in better management of the risks inherent in a Shipper insolvency situation. We believe that current arrangements allow for the risk (that an insolvent shipper leaves unpaid BPP debts) to be properly and efficiently by all parties. Also, because the proposal would burden Shippers with a risk they are less able to manage than Vector, the cost of managing that risk is likely to be greater.

## 3.5 Invoicing

### Current arrangements and proposed change

Currently, Vector utilises allocations advised by an Allocation Agent (generally under the Gas (Downstream Reconciliation) Rules 2008) in producing invoices.

The proposal would codify (new section 6.7) the concept that Vector is entitled to rely on such allocations.

In the invoicing and payment section (section 16), the proposal makes a number of consequential changes, clarifications, corrections to cross-references, and minor modifications. We only consider the substantive changes to this section which relate to disputed invoices and over and under-charges.

In regard to disputed invoices, the proposal extends the application of the section (section 16 .17) to cover Parties rather than just Shippers. This recognises that Vector should also be able to raise disputes in relation to amounts invoiced. The proposal also requires Shippers to pay at least half of any disputed invoice to Vector, pending resolution of the dispute.

In regard to over or undercharges relating to the BPP account, the proposal makes it clear that Vector will not issue invoices or credit notes except where it has made a manifest error or omission in using information, or where Maui supplied information is found to be incorrect and BPP corrections result (ie the situation of the final line in Table 3).

The proposal codifies current practice in relation to over or undercharges of transmission fees; ie when a delivery quantity is revised, a credit or debit note is issued.

The proposal imposes the 18 month deadline for reopening invoices to apply to BPP amounts as well as transmission fees, although this may be extended to 30 months for a transmission charges invoice if it relates to a special allocation performed under the Gas (Downstream Reconciliation) Rules 2008.

## Evaluation

We consider that the objective most relevant to a consideration of the proposed change is the Gas Act provision that 'risks relating to security of supply, including transport arrangements, are properly and efficiently managed by all parties'.

In its submission MRP notes that it does not support the proposed changes to the disputes procedures in section 16.17 as they would introduce unnecessary complexity. It appears to us that the main effect of the proposal is that parties should pay half of disputed amounts pending settlement. We consider that this does create appropriate incentives (to quickly resolve disputes), and does not seem needlessly complex.

We find that the proposed change clarifies a number of features of invoicing, and is likely to result in more effective resolution of disputed invoices.

# 4 Draft Recommendation

While the Change Request appeal has been presented as an 'invoicing' change, the proposal relates to peaking, corrections and prudential requirements, Shipper insolvency and invoicing. These are rather diverse topics and, as noted by submitters, more easily dealt with as subject specific change requests. Certainly, the only robust approach to analysing such diverse proposals is on a subject by subject basis, as we have done in this draft recommendation. In relation to these components we find that:

- **Peaking**: the proposed change would remove Vector's ability to channel peaking costs to causers, although we acknowledge Vector currently does not have the information it needs to use these provisions. It does not appear to further the Gas Act objective of ensuring that risks relating to security of supply, including transport arrangements, are properly and efficiently managed by all parties. Nor would it serve to keep downward pressure on costs or effectively signal costs to end users.
- **Corrections:** the proposal does appear to allow improved scope for error correction. Vector has advised us that the costs of this enhancement are not significant; the proposal would therefore efficiently improve the management of risk.
- **Prudential requirements:** the proposed change does generally clarify the prudential requirements and raises no concerns of increased barriers to entry.
- **Shipper insolvency: unpaid fees:** the proposal will not result in the better management of risks inherent in a Shipper insolvency situation, nor would it serve to keep downward pressure on prices.
- **Invoicing:** the proposed change clarifies a number of features of invoicing, and is likely to result in more effective resolution of disputed invoices.

Gas Industry Co is required to make a single recommendation on the proposed change, and cannot separate or otherwise materially change it. The scope of the proposed change has made it difficult for Gas Industry Co to arrive at an overall view. However, our concerns in relation to peaking and shipper insolvency are sufficiently significant for us to conclude that it is prudent not to support the proposal. The changes proposed in both areas seem to move against achieving Gas Act objectives, and be likely to reduce efficiency by removing an option to target costs and allocating risk to parties least able to manage the risk.

Gas Industry Co does not support the change request.

# 5 Next steps

Gas Industry Co invites submissions on this Draft Recommendation.

Submissions are due by 5pm, 28 May 2012. Please note submissions received after this date may not be considered.

Gas Industry Co will acknowledge receipt of all submissions electronically. If you do not receive electronic acknowledgement of your submission within two business days, please contact Jay Jefferies on 04 494 2469.

Gas Industry Co values openness and transparency and usually places submissions on our website. If you intend to provide confidential information in your submission, please discuss this first with Ian Wilson at Gas Industry Co (04 494 2462).

Gas Industry Co aims to make its Final Recommendation to Vector in late June 2012.

# Appendix A Summary of submissions on Draft Recommendation

| Submitter | Submitters comment |
|---|---|
| Genesis Energy | Genesis Energy:<br>• does not support the change request because it considers that the allocation of unrecovered balancing charges in the event of shipper insolvency is a substantial issue that should be assessed on its individual merits.<br>• prefers that change requests relate to a single issues, or related issues. It considers that the change request relates to a number of substantial, unrelated issues. Supports the MRP change request. Suggests that GIC should give due consideration to the fact that some of the changes included in the Vector change request do not have industry wide support.<br>• considers that Vector is best able to manage the risks of shipper insolvency through its prudential requirements. It strongly disagrees with the proposed allocation of unrecovered balancing charges from shippers.<br>• considers the absolute obligation on it to provide a shipper who has acquired one of its customers with information relevant to that customer that Vector has requested (proposed change to section 4.19) may cause it to breach confidentiality arrangements it has with that customer. |
| Mighty River Power | Mighty River Power:<br>• considers that Vector should not have mixed its change request with elements that shippers support, and elements that they do not support.<br>• considers, in relation to peaking, that Vector should make greater efforts to obtain the information necessary to allocate peaking costs, before advocating changes to section 8.13(b).If there are issues with obtaining any particular information, industry should attempt to resolve these. MRP would only support changes if the identified issues cannot be resolved.<br>• supports the proposed changes to corrections.<br>• Believes, in relation to Shipper insolvency, that Vector has sufficient cover through current prudential arrangements. It also notes that if Non-Code Shippers do not accept the proposed change, the burden on other Shippers will be even greater.<br>• except for the proposed changes to section 14.5, does not support the proposed change to prudential arrangements.<br>• in relation to invoicing, MRP does not support the proposed changes to the disputes procedures in section 16.17 as they would introduce unnecessary complexity.<br>• supports proposals for other invoicing changes. |

| Submitter | Submitters comment |
|---|---|
| Nova Energy | Nova Energy:<br>Considers that the proposal is, on balance, detrimental to Shippers. It believes the proposals in relation to peaking and corrections are positive, but those relating to invoicing and retailer insolvency are to the benefit of Vector and detriment of Shippers.<br>• Believes the retailer (Shipper) insolvency issue is of particular concern because:<br>o Shippers have no means of exercising control over other Shipper's default risk; and<br>o Shippers contract with Vector for transmission services is bilateral in nature and shippers have no contractual nexus in order to be able to pursue another defaulting Shipper;<br>o Vector is the appropriate party to bear Shipper default risk as they have rights under the VTC in relation to invoicing, payment, dispute resolution, and prudential supervision.<br>• believes the MOU gives an incentive for change requests to bundle unrelated positive and negative changes. Nova considers Gas Industry Co should be entitled to consider a rule change (or appeal) in part as well as a whole, and to make approval conditional where appropriate. |

# Glossary

**Note:** Definitions obtained from the VTC or MPOC are shown in *italics*.

| | |
|---|---|
| balancing | The management of Line Pack to ensure that it remains within acceptable operational limits. |
| Balancing Agent | Defined by the MPOC as *'…the balancing agent appointed by MDL from time to time to manage the Line Pack.'* The October 2011 change request does not propose changing this definition. |
| balancing gas | Defined in the MPOC as *'…Gas used to manage Line Pack on a Transmission Pipeline.' '* |
| BPP | 'Balancing and Peaking Pool'. A mechanism in the Vector transmission regime to ring-fence and allocate balancing costs via a trust account. |
| imbalance | 'Operational imbalance' in the MPOC is the difference in scheduled flows and actual flows at an interconnection point. |
| MPOC | 'Maui Pipeline Operating Code', the current version of which is dated 1 September 2011. |
| Non-Code Shipper | Defined by the VTC as '… any party with whom Vector has a transmission services agreement with a commencement date prior to 1 December 2007, the terms of which are consistent with the principles set out in Schedule 9 of the MPOC, and which contains a provision that is substantially the same as the Balancing and Peaking section in Vector's immediately preceding transmission services agreements prior to 1 December 2007, but which does not include all of the same provisions as section 8 of this Code in substantially the same form as they appear in section 8' |
| Shipper | A pipeline user that has contracted for the TSO to transport gas. |
| TPWP | Currently Vector is the only Transmission Pipeline Welded Party under the MPOC. 'TP Welded Party' is defined by the MPOC as '…in respect of a Transmission Pipeline, a Welded Party that controls that Transmission Pipeline.' |
| TSO | 'Transmission System Owner'. |
| VTC | 'Vector Transmission Code'. |