



Draft Recommendation on 13 April 2016 MPOC Change of Ownership Change Request (COCR)

14 April 2016

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'.

DATE ISSUED:

14 April 2016

INQUIRIES:

(+64) 4 472 1800

Executive summary

The Maui Pipeline is about to be sold, and the existing owners are proposing a change to the access code to facilitate the change in ownership and operation of the pipeline.

The current and prospective owners have been discussing draft change proposals with pipeline users for several months and now seek Gas Industry Co's support for a proposed code change that they believe has user support.

Gas Industry Co has considered the proposal with reference to Gas Act objectives. We find that most of the proposed edits to the code are minor and common sense. Only a few more extensive changes to the confidentiality provisions require detailed analysis. These will allow the new owner to bring the Technical Operator, System Operator, Commercial Operator, Balancing Agent and Incentives Pool Trustee roles in-house, while preserving (and certifying) ring-fencing where necessary.

Overall, we conclude that the proposal provides a concise set of changes that accord with the Gas Act objectives, accommodate the changing ownership of the pipeline, and will avoid a misalignment of the MPOC and the prospective new owner's business (that would occur if the MPOC is not changed).

Given the limited scope of the proposal, and the degree of engagement between the owners and existing pipeline users, we consider that an expedited consultation process is appropriate. We are therefore calling for submissions on both the proposed change and this Draft Recommendation, which supports the proposed change, by **5.00pm, Friday 29 April 2016**.

Contents

| | | |
|-----------|---|-----------|
| 1. | Introduction | 6 |
| 1.1 | Purpose of the proposed MPOC change | 6 |
| 1.2 | Background | 6 |
| 1.3 | Gas Industry Co's role under the MPOC | 7 |
| 1.4 | Process | 7 |
| 1.5 | Use of capitalised terms in this Draft Recommendation | 8 |
| 1.6 | Invitation for submissions | 8 |
| <hr/> | | |
| 2. | Proposed Changes | 9 |
| 3. | Assessment of Proposed Changes | 10 |
| 4. | Draft Recommendation | 16 |

1. Introduction

1.1 Purpose of the proposed MPOC change

On 13 April 2016, Gas Industry Co received an application from Maui Development Limited (MDL) seeking Gas Industry Co's support of proposed amendments to the Maui Pipeline Operating Code (MPOC). The proposed amendments aim to facilitate a change in the ownership and operation of the Maui Pipeline. We refer to the set of documents associated with MDL's change request proposal as the Change of Ownership Change Request (COCR). The COCR comprises:

- Application for Gas Industry Co's recommendation;
- red-lined MPOC; and
- a Deed of Covenant for the assignment of contracts to the new owner.

The 13 April 2016 MPOC Change of Ownership Change Request (COCR) would come into effect as soon as a Gas Industry Co Final Recommendation supporting the Change Request is issued. This could be as soon as 4 May 2016, assuming no substantive issues are raised in submissions, and that Gas Industry Co continues to support the COCR. Among other matters the COCR:

- removes references to MDL;
- provides that the new owner can carry out the Technical Operator, System Operator, Commercial Operator, Balancing Agent and Incentives Pool Trustee roles; and
- adjusts the ring-fencing arrangements to be appropriate for the changed circumstances.

1.2 Background

In November 2015 the conditional sale of Vector Gas Limited (VGL) was announced. This was followed, in December 2015, by an announcement that the Maui Pipeline would also be sold. The prospective new owner of both pipelines are infrastructure funds and investors managed by Colonial First State Infrastructure Managers (Australia) Limited, Colonial First State Management Infrastructure Limited and First State Infrastructure Managers (International) Limited (collectively known outside of Australia as First State Investments) (FSI).

FSI proposes initially to complete the acquisition of VGL, after which VGL will complete the acquisition of the Maui Pipeline. However, the proposed MPOC changes would come into effect as soon as Gas Industry Co's Final Recommendation is notified (assuming it supports the COCR). The drafting of the MPOC changes therefore relates to the situation both before and after the Effective Date (the date on which MDL notifies pipeline users that the acquisition is complete). This should smooth the transition for the new owner and its customers; the Maui Pipeline Shippers and Welded Parties.

More detailed background information is provided in MDL's COCR Application.

1.3 Gas Industry Co's role under the MPOC

Section 29 of the MPOC assigns Gas Industry Co a role in respect of any MPOC change request; to consult on the change request with the gas industry and determine whether or not to support it. Gas Industry Co's Memorandum of Understanding with MDL (MoU) describes how the Company's role in relation to change requests will be performed. Although the MoU is not legally binding, Clause 2.3 of the MoU provides for Gas Industry Co to have regard to the objectives set out in section 43ZN of the Gas Act when it considers change requests. Gas Industry Co otherwise has broad discretion in determining what considerations could be relevant (consistent with its statutory powers and functions).

The MoU also sets out a process under which Gas Industry Co receives a change request; calls for submissions; issues a draft recommendation which includes an analysis of the issues under consideration and a cost-benefit analysis; considers further submissions; and makes a final recommendation to MDL. Gas Industry Co can supplement this process, including by calling for cross-submissions, or expedite it.

Under the MoU process, Gas Industry Co assesses whether a change request will bring improvements relative to the status quo. Gas Industry Co cannot reject a change request because it believes it is not ideal, or that there may be a better alternative, or that there are additional things that should be done.

A change request proceeds only where required by law or where Gas Industry Co makes a written recommendation supporting the change request. The MoU then provides that MDL also has sole discretion not to give its written consent to a change request if it considers that: the change would materially adversely affect its Maui Pipeline business or tariffs or a Transmission Pipeline Welded Party's transmission pipeline business; the change would require MDL to incur capital expenditure, or to incur operating expenses or costs that cannot be recovered, or materially adversely affect the compatibility of MDL's open access regime with that of a Transmission Pipeline Welded Party.

For further information on Gas Industry Co's role under the MPOC (including a copy of the MoU) please refer to Gas Industry Co's website at <http://gasindustry.co.nz/dmsdocument/4144>

1.4 Process

In January 2016, Gas Industry Co discussed early drafts of the COCR with the current and prospective owners, MDL and FSI. In the following months the COCR was refined through discussions between the owners and pipeline users until the owners were confident that the COCR was in a form acceptable to the Maui Pipeline Shippers and Welded Parties.

Given the limited scope of the COCR and the extent of pre-consultation, FSI asked Gas Industry Co to consider an expedited process. Gas Industry Co agrees that an expedited process is appropriate, providing no substantive issues are raised by stakeholders at any stage.

Accordingly, we consider that it is appropriate to issue this Draft Recommendation at the same time as the Change Request and, assuming that no substantive issues are raised in submissions, the timetable will be as follows:

| | |
|--|--------------------------|
| MDL formally submits COCR to GIC | Wednesday, 13 April 2016 |
| GIC issues COCR and Draft Recommendation and calls for submissions | Thursday, 14 April 2016 |
| Submissions on COCR and Draft Recommendation close | Friday, 29 April 2016 |
| GIC issues Final Recommendation (assuming no substantive issues are raised in submissions) | Wednesday, 4 May 2016 |

1.5 Use of capitalised terms in this Draft Recommendation

Terms that are capitalised are terms that are defined either in the current MPOC or in the MPOC as modified by the COCR, as the context dictates.

1.6 Invitation for submissions

Gas Industry Co invites submissions on the COCR and this Draft Recommendation.

Submissions are due by **5.00pm, Friday, 29 April 2016** and can be made by visiting our website. Please note submissions received after this date may not be considered

Gas Industry Co values openness and transparency and will post submissions on our website www.gasindustry.co.nz. If you intend to provide confidential information in your submission, please discuss that with us first.

2. Proposed Changes

Full details of the proposed change are provided in the MDL's COCR. The merits of these changes are discussed in the next chapter. Here we outline the essential features of the proposed changes.

In essence, the proposed changes involve:

- replacing Maui Development Limited ('MDL') with Transmission Service Provider ('TSP');
- providing that the TSP can carry out the Technical Operator, System Operator, Commercial Operator, Balancing Agent and Incentives Pool Trustee roles (at present these roles are variously carried out by Vector and Transact); and
- adjusting the ring-fencing arrangements to be appropriate for the changed circumstances.

The most significant changes proposed by the COCR occur in clause 24 Confidentiality, and the related Schedule 4 Confidentiality Protocols. In essence, the changes recognise that the new TSP will be less conflicted than MDL, because it is not involved in gas production, but still has the potential to affect competition in related markets through its involvement in Balancing Gas and Fuel Gas. The proposed changes also address the possibility that the TSP, or a Related Company, may in future become a gas producer or trader.

3. Assessment of Proposed Changes

3.1 Evaluative criteria

In performing its roles and functions specified in the MPOC, Gas Industry Co must have regard to the objectives specified in section 43ZN of 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.

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.

In relation to the COCR, the changes to clause 24 Confidentiality, and the associated Schedule 4 Confidentiality Protocols relate mostly to the Gas Act objective of minimising barriers to competition.

3.2 Analysis

In considering the proposed MPOC changes it is helpful to remember the dynamics that influenced the original code development. The MPOC was developed through a Government sponsored process involving broad stakeholder representation. The pipeline was previously dedicated to serving Maui Gas contract holders, and not open to third parties. The MPOC development process recognised that access to the pipeline was a matter of national importance, and that its owners – companies from the Shell group, Todd Petroleum Mining Limited and OMV New Zealand Limited; collectively known as the Maui Mining Companies – had upstream and downstream business interests giving rise to potential conflicts of interest and competition concerns.

Some key provisions of the MPOC, such as the ring-fencing of certain commercially sensitive information, were designed to address those conflicts of interest and ensure non-discriminatory access to the pipeline. Also, the critical Maui Pipeline operational roles of Technical Operator, System Operator and Commercial Operator were outsourced to facilitate this, including the Commercial Operator performing the Balancing Agent and Incentives Pool Trustee roles.

In contrast, the new owner will not (at least initially) have any interests in gas exploration, gas production, gas wholesaling or gas retailing. The extent of its vertical integration will be through its ownership of a number of gas distribution networks, and this is much less of a concern from a competition policy perspective. And its gas trading will only involve Balancing Gas and Fuel Gas. However, unlike many overseas jurisdictions (such as the US and EU) there are no statutory barriers to a transmission pipeline owner in New Zealand also having upstream or downstream interests, so it is possible that the new owner could acquire such interests in the future.

The COCR needs to be assessed with these considerations in mind.

'MDL' to be replaced by 'TSP'

In the current MPOC 'MDL' means Maui Development Limited. 'Transmission Service Provider' (TSP) is a proposed new term meaning '... the person that is the transmission services provider from time to time, currently being MDL, and on and from the Effective Date being VGL.'

Assessment

We believe that parties to TSAs and ICAs are unlikely to be concerned about VGL replacing MDL as the TSP; both are counterparties with substance and reputation. For the same reasons we have no concerns.

Definitions

The changes to clause 1 Definitions and Interpretation are generally unremarkable, but a couple of new definitions deserve mention.

The Maui Pipeline definition has been modified to make it clear that, after the acquisition, it excludes '...the transmission system governed by the Vector Transmission Code.'

'Related Company' is to have the same meaning as in the Companies Act 1993.¹

This term is relevant only to a new ring-fencing provision, discussed below.

'Effective Date' is defined as '...the date notified by MDL in writing to Gas Industry Co, Shippers and Welded Parties on which VGL completes the acquisition of the Maui Pipeline.

¹ Generally companies are related if one is a holding company and one is a subsidiary; or one owns more than half the other; or their business activities are not easily distinguished; or both are related to another company.

Note that this is the date that ownership changes and not the date that the COCR will take effect. The Application states that the MPOC would be revised as soon as a Gas Industry Co Final Recommendation supporting it is issued. The COCR drafting reflects this. For example, the proposed new TSP definition refers to the TSP ‘... currently being MDL...’. Also various other revised definitions are split into an ‘... (a) up to the Effective Date...’, and a ‘...(b) on and from the Effective Date’.

Assessment

We consider that the revised definition of the Maui Pipeline, and the introduction of the term ‘Related Company’, as defined in the Companies Act, both add clarity.

We have no problem with the definition of the Effective Date, but note that it would not be required, and nor would the related ‘up to...’ and ‘on and from...’ drafting be required, if the COCR only came into effect on completion of the pipeline acquisition. However, we accept that the pre-consultation has been in relation to the current drafting, and it may be too late to make a wholesale change. Nonetheless, if MDL did wish to change the proposed implementation date to be the Effective Date, and to revise the proposed MPOC edits accordingly, we would consider those changes to be ‘minor and technical’ in nature.

Confidentiality

The most significant changes proposed by the COCR occur in clause 24 Confidentiality, and the related Schedule 4 Confidentiality Protocols.

The existing clause 24.1(a) requires MDL to keep management of the Maui Pipeline ‘... at arm’s length and separate...’ from any other businesses it has, and from those of its shareholders (ie the Maui Mining Companies). In particular, the subsections provide that this applies to:

- scheduling functions, to be contracted to a System Operator;
- technical functions, to be contracted to a Technical Operator;
- commercial functions, including managing Balancing Gas and Fuel Gas, to be contracted to a Commercial Operator; and
- ring-fencing these Operators, and the Balancing Agent and Incentives Pool Trustee, according to the provisions of Schedule 4.

The COCR leaves this provision in place, but a new clause 24.2(b) provides that from the Effective Date it will only apply if the TSP, or a Related Company, becomes a gas producer in New Zealand. So, if the new TSP should ever become a gas producer, like the current pipeline owners, it will be subject to the same clause 24.1(a) behavioural requirements as the current owners.

In addition, whether the TSP, or any Related Company, is a gas producer or not, a new set of clauses - 24.1(b)(ii)-(vi) - apply.

Clause 24.1(b)(ii) provides a set of over-arching undertakings that the TSP will:

- not give priority treatment to any user, and particularly not enter into any arrangements or act in a way that would give priority treatment to any end-user;
- provide open, arm's length access to the Maui Pipeline; and
- comply with Schedule 4.

Clause 24.1(b)(iii) provides that the formation and management of Balancing Gas and Fuel Gas contracts are only done by non-conflicted employees, and in a secure environment.

Clause 24.1(b)(iv) provides that any other TSP gas trading activity is similarly ring-fenced.

Clause 24.1(b)(v) extends 24.1(b)(iv) to also cover the gas trading activity of any Related Company.

Clause 24.1(b)(vi) requires the TSP to provide an annual audit certificate certifying compliance with the above.

In relation to Schedule 4 Confidentiality Protocols, the proposed changes generally serve to recognise that special treatment of the Maui Mining Companies will not be necessary after the Effective Date. Deserving closer attention are the changes to section 8. The existing section 8 clauses set out behavioural requirements on the System, Technical and Commercial Operators. Basically these are that Operators don't give preferential treatment to any pipeline user, or enter into arrangements that would do so, or act in a manner that would result in preferential treatment. And that the business accommodation and systems also serve those objectives.

The COCR proposes adding a new clause 8.1, which disables the existing section 8 clauses from the Effective Date, and a new clause 8.4, which would enable them again if the TSP (or a Related Company) ever becomes a gas producer. The COCR assumes that if the TSP is not a gas producer, the provisions of clause 24.1(b)(ii)-(vi) provide adequate protection.

Assessment

As mentioned earlier, we consider that the Gas Act objective of minimising barriers to competition is most relevant to consideration of the COCR. A useful framework in that regard is the 'good behaviour' principles developed in the US and largely imported by other jurisdictions seeking to promote open access to essential infrastructure.² These principles aim to protect competitive neutrality in related upstream and downstream markets. Broadly they are:

- 'non-discrimination' – to ensure that the pipeline owner treats similar customers in the same way. In particular, it is expected that pipeline prices and scheduling shouldn't discriminate

² <http://www.ecfr.gov/cgi-bin/text-idx?c=ecfr&SID=d48bd001f3e35e819a39b6cc0c91b675&rgn=div5&view=text&node=18:1.0.1.17.75&idno=18>

among customers (except in a few circumstances such as for large anchor loads, or between firm and interruptible users);

- the 'independent functioning rule' – requiring pipeline operations staff be separated from, and barred from communicating with, any staff involved in the marketing of gas;
- the 'no conduit rule' – preventing any third party from passing information between the pipeline operations staff and pipeline marketing staff; and
- the 'transparency rule' – requiring pipeline information to be disclosed to all pipeline users, potential users, and the pipelines marketing staff, at the same time.

Under the COCR, if the TSP, or any Related Company, ever become a gas producer in New Zealand, clause 24.1(b)(i) would put the same requirements on it as applied to MDL. However, all the additional requirements of clause 24.1(b)(ii)-(vi) would also apply, including annual certification. So the non-discrimination aspect of the code would be strengthened.

If the TSP, or any Related Company, remains uninvolved with gas production, then the '... at arm's length and separate...' provisions binding each Operator, the Balancing Agent and the Incentives Pool Trustee to comply with the Schedule 4 Confidentiality Protocols no longer apply. This would allow all these functions to be dealt with by the TSP, subject only to the new clause 24.1(b)(ii)-(vi) requirements discussed above. Importantly, in all situations:

- non-discrimination principles would apply (clause 24.1(b)(ii));
- Balancing Gas and Fuel Gas contracts, and gas trading by the TSP or any Related Company, would be dealt with by non-conflicted employees, in a secure environment (clause 24.1(b)(iii),(iv) and (v)); and
- an audit certificate from the TSP's external auditor certifying compliance with the above will be issued to Shippers and Welded Parties each year (clause 24.1(b)(vi)).

If the TSP is not involved in gas production, there is considerably reduced cause for concern about competition being damaged because of TSP behaviour favouring particular parties (especially affiliated businesses). So it could be argued that the clause 24.1(b) requirements are excessive. However, as mentioned earlier, there is nothing to prevent the TSP, or a Related Company, becoming involved elsewhere in the supply chain (as a gas retailer, for example). In that circumstance the new clause 24.1(b) does provide safeguards.

Also, it should be remembered that the MPOC is a living document. It does not need to address all conceivable eventualities. If circumstances change, and stakeholders believe that it no longer provides sufficient protection, they can propose changes.

Deed of Covenant

MDL has included a Deed of Covenant (prepared by FSI) with the COCR. This is a deed in favour of Shippers and Welded Parties, pursuant to clause 36 of the MPOC, by which the new owner makes commitments in respect of honouring contracts assigned to it, and only making future assignments of those contracts if certain conditions are met.

Assessment

We do not consider that the Deed of Covenant is in itself a change to the MPOC. Rather it is a document that is required by the MPOC when Transmission Services Agreements (TSAs) and Interconnection Agreements (ICAs) are assigned. While the Deed of Covenant appears to be comprehensive and compliant, we leave it to individual Shippers and Welded Parties to make their own legal review and, if they have concerns, to discuss those with FSI.

3.2 Overall Assessment

We find the COCR substantially involves common sense changes, required because the MPOC needs to reference a new owner. However, a small number of changes arise from that new owner having a fundamentally different business model to the current owner, and we have analysed these in more detail. We conclude that:

- initially, the TSP's only other involvement in the supply chain is through its ownership of some distribution networks, and the non-discrimination provisions of new clause 24.1(b)(ii) together with the annual audit specified in the new clause 14.1(b)(vi) should provide adequate protection;
- if the TSP, or a Related Company, should ever become a gas producer, the COCR provides all the protection of the current MPOC arrangements, plus the added protection of the new clause 24.1(b)(ii)-(vi) arrangements; and
- if the TSP, or a Related Company, should ever become involved elsewhere in the supply chain (for example, by becoming a gas retailer), protection is provided by the non-discrimination principles of the new clause 24.1(b)(ii), the gas trading separation provided by (new clause 24.1(b)(iii),(iv) and (v)), and the audit requirement of new clause 24.1(b)(vi).

In summary, we conclude that the COCR provides a concise set of changes that accord with the Gas Act objectives, accommodate the changing ownership of the pipeline, and will avoid a misalignment of the MPOC and the prospective new owner's business (that would occur if the MPOC is not changed).

4. Draft Recommendation

At this stage our analysis supports this change request. We welcome submissions on the COCR, this Draft Recommendation, and whether you have any concerns with the expedited consultation process.

Provided no material concerns are raised in submissions, Gas Industry Co will make a Final Recommendation without any further consultation on this matter.