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65/Commerce Commission/ Submission 030820

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Mr David Steele
Commerce Commission
Level 6, NGC Building
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Wellington

Dear Mr Steele

SUBMISSIONS ON GAS CONTROL INQUIRY DRAFT FRAMEWORK PAPER

Thank you for inviting us to comment on the Draft Framework Paper of 16 July 2003.

Introduction

Maunsell Meritec welcomes the opportunity to contribute to the inquiry with our experience from working as independent consultants with both the gas industry and the government. Maunsell Meritec and its predecessors have had a more than 20-year relationship with this industry starting from the early days of CNG and have been involved in numerous roles in design, operations, asset management and business management. We have had extensive involvement in valuations of transmission and distribution businesses for financial reporting, information disclosure, due diligence, district role and insurance purposes. Maunsell Meritec was co-author of the Draft Gas ODV Handbook.

We believe that the Draft Framework Paper raises a number of valid considerations and that it should be possible to formulate recommendations to the Minister that are in the best interests of both the gas industry and those parts of New Zealand society that are served by this sector.

Background

The natural gas industry of New Zealand has developed over a period of 30 years and has now reached a mature stage with a well-established infrastructure of networks, a large population of industrial and residential gas appliances and a good safety record. One of the biggest current concerns of the industry is the ongoing supply of gas to meet the potential increase of commercial and residential demand. With an early discontinuation of methanol exports and the further development of new gas fields it is likely though that the demand will be met for at least another 30 years.

A further concern of the industry is its regulatory stability. The past decade of regulatory changes and industry restructuring has caused a degree of disruption to most of the pipeline businesses and the industry would benefit from a period of regulatory stability in order to recover from the loss of human resources, data and systems that followed the many restructurings all too often.

With only 220,000 connections on the North Island the gas industry is relatively small, not only in comparison with the electricity industry with about eight times as many connections, but also with other infrastructure

industries in New Zealand such as roading and water as well as gas networks overseas. On the scale of the industry it is surprising that the government has changed the regulatory framework this often (in about 10-year cycles) and industry participants as well as the wider public may request some explanations about the effectiveness of regular changes and their economic efficiency.

Considering the introduction of the current Gas Act in 1992 and its control mechanism (the Gas Information Disclosure Regulations) in 1997, with the valuation rules still not promulgated, there may be too little experience and evidence that could suggest that the current regime of self-regulation through information disclosure is not sufficient.

Our Comments

As independent consultants we are commercially not affected by any of the control mechanisms under investigation and we therefore can express our views in an unbiased way. We are interested in a regulatory framework that best serves all involved parties and provides overall economic efficiency. The following is a list of principle comments that in our opinion could be considered in the inquiry:

1. “KEEP IT SIMPLE”

The New Zealand gas industry is tiny on an international scale and cannot afford the bureaucracy of heavy-handed regulations. Any of the economic control tools such as ODV or WACC calculations must be written in plain English and easy to understand by the widest possible audience. These tools will need to be applied by marketing personnel, engineers and accountants at a middle management level.

2. Market Boundaries

In considering competitive or non-competitive market environments the market boundaries or sectorisation should be put into perspective with the size of the industry. Is it appropriate to look at individual pipeline businesses, parts of such businesses or even individual pipeline sections? Could one take a wider view and look at the industry as a whole including production, transmission, distribution and utilisation? If the latter were the case, the investigation would concentrate on the question whether gas supply as a whole actively competes with alternative forms of energy supply such as electricity, fuel oil, coal or renewable energy. This approach could simplify the inquiry and would take the investigation to the question whether the few industry participants (upstream and downstream) are able to self-control the pricing amongst themselves.

3. Evidence

The current control mechanism is based on industry self-regulation through information disclosure. While the Commission was asked to look at an alternative it should also investigate and provide clear evidence that the current regime is not working properly.

4. Improvement of Current Control Mechanisms

The key commercial tool for measuring profits of pipeline businesses has been the ODV. It was only in 2000 that the Ministry of Economic Development circulated the Draft Handbook for comments, which was put on hold when the ACIL Report was commissioned shortly after (this report could be a starting point for the inquiry). Despite the fact that the ODV Handbook was not promulgated the industry has used the principles for its information disclosure and financial reporting. We believe that it is most important that the valuation methodology is clearly spelt out regardless of the control mechanism, information disclosure or price regulation.

5. Flexibility in a Changing Market Environment

With possibly slowly declining gas reserves and increasing energy demand, New Zealand will be faced with many new challenges in providing energy technologies that secure the future demand and meet New Zealand's environmental standards. It is highly desirable that a regulatory framework does not stifle investments that may lead to a higher degree of efficiency and reliability.

6. Industry Development

In view of the need for encouraging exploration in New Zealand the downstream gas industry should be highly motivated to keep natural gas competitive with other fuels. We assume that it has a strong self-interest in co-ordinating through pricing mechanisms both the demand and supply side of the business to enable maximum customer satisfaction and economic efficiency.

7. Energy Policy

Gas has played a significant role in New Zealand's energy scenario in the past 30 years and will continue to do so in the future. Due to past price regulations, a large part of the reserves has been wasted or exported overseas. In economies such as Japan or Europe, natural gas is regarded as a premium fuel to provide security for peak energy demand. New Zealand is likely to face similar demands on its remaining gas reserves in the future, and the pricing will need to reflect this situation. With this in mind, the inquiry should investigate which control mechanisms will best serve this trend.

8. Risks of Price Control

The Draft Framework Paper quite correctly addressed some of the risks of price control such as:

- cost to the industry;
- potentially incorrect decisions;
- economic inefficiency and
- gaming by market participants under a new regulatory environment.

The commission should also consider the question whether the government has the ability and resources to control the prices and achieve economic efficiency.

9. Consistency

Through our work with ODVs we noted some inconsistencies between valuation methodologies, particular between the FRS-3 and the ODV Handbook, and also in view of the various applications of these rules such as for financial reporting, information disclosure, district role and insurance valuations. It would be highly desirable to ensure that a future framework will take care of consistency between the different legislations and clarity of the rules.

10. Timing of Implementation

The Commission should also consider an appropriate time frame for implementing the adopted framework. This will be important for the regulatory confidence of the affected companies and for their medium-term adjustment to the changed environment. One possible solution could be the specification of a time frame for the current regulations to mature and to prove its economic efficiency (or inefficiency).

We are interested in presenting and discussing these points at the Conference.

Yours sincerely

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