

Gas Control Inquiry

Draft Report



Submission to Commerce Commission
2 July 2004

CONTACT ENERGY LIMITED

Contact is the third largest company on the New Zealand stock exchange, with over 100,000 New Zealand shareholders.

Contact is a significant acquirer and retailer of gas in the New Zealand, supplying electricity and/or natural gas to more than 600,000 businesses and homes nationally. Contact is responsible for over a quarter of the country's electricity generation, and acquires gas for the purpose of fuelling its combined cycle stations at Taranaki and Otahuhu. It also uses gas in a cogeneration plant at Te Rapa, a steam turbine station at New Plymouth, and, more rarely, in single cycle gas turbines at Otahuhu. Contact is the largest retailer of natural gas in the country, supplying some 40% of the retail market.

Contact is the largest supplier of meters to the gas retail market.

For further information on this submission please contact:

Jennifer Wattie

Regulatory Analyst

DDI (04) 462 1233

jennifer.wattie@contact-energy.co.nz

READING THIS SUBMISSION

This submission is structured in two parts: the first section presents Contact's general response to the report, and the subsequent section sets out its response to the specific questions posed by the Commission.

Table 1: Abbreviations Used in this Submission

Abbreviation	Full Expression
"Contact"	Contact Energy Limited
"Lally"	<i>The weighted average cost of capital for gas pipeline businesses, Report to the Commerce Commission, Martin Lally, 14 May 2004.</i>
"MDL"	Maui Development Limited
"MED"	The Ministry of Economic Development
"NGC"	Natural Gas Corporation, both transmission and distribution.
"The Commission"	The Commerce Commission
"The framework paper"	The Commerce Commission's Gas Control Inquiry draft framework paper, dated 16 July 2003
"The report"	The Commerce Commission's Gas Control Inquiry draft report, dated 21 May 2004
WACC	Weighted average cost of capital

References to the report are shown as references to a paragraph number in parenthesis e.g. {150} references paragraph 150 of the report.

TABLE OF CONTENTS

1.	Summary	2
1.1	NGC Transmission and Distribution, Powerco, and Vector	2
1.2	Wanganui Gas	2
1.3	Nova Gas	2
1.4	Maui	2
1.5	Taranaki Pipelines	3
1.6	Valuation Methodology	3
2.	Contact's Submission	4
2.1	The Market for Gas Services	5
2.1.1	Gas Services Bundled with Gas Energy	5
2.1.2	Bundled Component Gas Services	6
2.2	Un-bundling not part of the counterfactual	6
2.3	Transport of gas	7
2.3.1	Transmission	7
2.3.2	Distribution	10
2.4	Allocation (Metering and Reconciliation) of gas	11
2.5	Non-transport Pipeline Operations	11
2.6	Behaviour of Gas Retailers who also Generate Electricity	12
2.7	Measuring Efficiency Gains	12
2.7.1	Efficiency Gains through Regulatory Consistency	12
2.7.2	Benefits of consistency with control of electricity lines	13
2.7.3	Benefits of consistency across the gas value chain	13
2.7.4	Direct Benefits of Control Understated	14
2.8	The Commission's Approach	14
2.8.1	Treatment of foreign ownership	15
2.9	The Potential Control Regime	15
2.9.1	The regulatory period	16
2.9.2	Determination of excess profits	17
3.	Responses to Specific Questions	19

1. SUMMARY

Contact agrees with the general conclusion of the report that gas services supplied by pipeline owners should be controlled because the Commission's analysis shows that control would provide a net benefit to acquirers of those services. However, Contact has reservations with the report in that the form of control it assesses:

- bundles gas services, instead of treating them separately. A number of the component gas services, such as metering, are contestable, and unbundling them would produce more efficient outcomes than control;
- focuses on price without regard to the quality of service; and
- does not recognise the benefits to acquirers of a consistent regime across interconnected pipelines.

With respect to the specific recommendations with which the report concludes:

1.1 NGC Transmission and Distribution, Powerco, and Vector

"... the gas services supplied by NGC Holdings Limited (Transmission), NGC Holdings Limited (Distribution), Powerco Limited, and Vector Limited should be controlled." {154}

Contact supports this recommendation.

1.2 Wanganui Gas

"... the gas services supplied by Wanganui Gas should not be controlled." {156}

Contact does not support this recommendation. The need for equity of treatment across the gas sector, particularly given the suggested ten year control period, and the report's findings of small but positive benefits of control to acquirers mean that Wanganui Gas should be subject to the same control regime as the other gas distribution companies.

1.3 Nova Gas

"... the gas services supplied by Nova Gas Limited should not be controlled." {158}

Contact does not support this recommendation. The market for by-pass pipelines is only distinct due to the bundling of gas energy and gas delivery by the by-pass owners. By-pass lines should be required to offer open access, with gas services subject to the same control regime as for other pipelines.

1.4 Maui

"... the gas services supplied by MDL, under the Maui open access regime, should be controlled." {163}

Contact supports this recommendation, but believes that the control regime should require a contract carriage rather than the proposed common carriage regime. A contract carriage regime would result in greater allocative efficiencies by enabling acquirers to value transport certainty, and to trade that certainty through a secondary capacity market,

1.5 Taranaki Pipelines

"... the gas services supplied by the LTS pipeline (NGC); Kapuni to Hawera Pipeline (Todd Petroleum and Shell); McKee Production Station to Faull Road (Todd Taranaki); Rimu to NGC South, Waihapa to New Plymouth Power Station and Waihapa to Stratford TCC Power Station (Swift Energy); and Surrey Road to NGC's LTS Pipeline (Westech) should not be controlled." {168}

Contact supports this recommendation.

1.6 Valuation Methodology

"... the appropriate valuation methodology ... is ODV." {169}

Contact supports this recommendation.

2. CONTACT'S SUBMISSION

Contact agrees with the general conclusion of the report that gas services supplied by pipeline owners should be controlled because the Commission's analysis shows that control would provide a net benefit to acquirers of those services. In this regard, it should be noted that the price of gas services is not the only issue faced by acquirers. The quality of services offered by gas pipeline owners is of equal concern, so that any eventual control regime will have to take account not just of price, but also of service offering.

Contact recognises the purpose of the Inquiry is to determine whether particular gas services should be subject to control and not to examine or address the specifics of a control regime. However, in order to identify benefits of control, the Commission has provided some preliminary indications as to the likely control regime. Whilst fully recognising that these do not represent definitive proposals on the control regime, Contact has noted several instances where they may depart from competitive sector outcomes. For Contact, the overriding principle of any regulatory regime is that it should produce efficient, fair and equitable outcomes for all parties, as is typified by markets in the competitive sector. Therefore, in reserving its position on the control regime until further details are known, Contact can signal that it is likely to support a regulatory control regime whose outcomes are more aligned with the competitive sector than those proposed in the report.

Contact expects market forces to produce more efficient outcomes than regulation where competition is possible. It follows that control should only be applied to those component gas services where competition is not feasible. The Commission's approach of bundling all gas services together precludes this occurring, and so a less efficient outcome may be expected than if gas services are unbundled and control applied only to those where competition is restricted.

In further support of the report's findings that control in some form should be imposed, Contact believes that weight should be given to the benefits of consistency of regulatory approach both in ensuring equity of treatment across gas suppliers and across energy forms. The value to acquirers of consistency of service offering between interconnected gas service providers leads Contact to question the report's acceptance of fundamentally different gas transmission regimes on the NGC and MDL pipelines. The need for consistency, together with the overwhelming conclusion that competition is limited and control is in the interests of acquirers, also leads to the view that the recommendations to exclude a number of companies from any control regime should be reversed.

In addition, Contact has a number of reservations with the Commission's methodology.

2.1 The Market for Gas Services

Although many submissions¹ on the draft framework paper identified component gas services to be evaluated, the report does not unbundle gas services. Rather, it goes further and bundles gas services with gas energy.

2.1.1 Gas Services Bundled with Gas Energy

The Commission clearly identifies the subject of the inquiry as “gas services, in particular those services directly related to gas transmission and gas distribution” {3.14}. Thereafter, however, this focus is blurred by bundling gas services with gas itself, following NGC’s observation that “demand for pipeline services is derivative from the demand for gas” {3.75}. Much of the competition analysis in the report consists of an assessment of whether gas competes with electricity or other energy equivalents. While this analysis provides insights into the degree of competition for gas services, it does also obscure several key features of the market under consideration:

- there is a difference between a supplier of pipeline services that is also a gas supplier, and a gas supplier that acquires pipeline services from a third party. The Commission notes {40} “... even if interfuel competition placed ... a ceiling on possible gas price increases, this increase could all be captured by the distributor in the form of a[n] .. increase in distribution prices, or by the transmitter in the form of a[n] ... increase in transmission prices”. The incentive for a transporter of gas to capture all of any possible gas price increase is greater for a bundled supplier of both gas and gas services than for a third party supplier of gas services alone. This is because the bundled supplier obtains the additional benefit of reducing the ability of its competitor gas suppliers to limit the price increase for the purpose of increasing market share.
- Pipeline services must be available to all acquirers equally for the market to be truly competitive. Thus by-pass can only be considered a fully competitive alternative if all acquirers can have access to by-pass lines. That does not just mean that all acquirers should have the ability to become suppliers of pipeline services through constructing by-pass lines, but also that all should have access to any by-pass lines constructed by others. Where the owners of by-pass pipelines do not offer third party access to those pipelines, then the competitive benefits of by-pass are not available to all acquirers, but only to those who are consumers of gas sold by the by-pass owner. Gas retailers who are potential acquirers of the gas services provided by the by-pass line do not benefit from it.

Clearly there are some customers who can switch energy forms: the recent example of Fonterra switching from gas to coal demonstrates this. Some customers can either threaten or actually construct by-pass. Even so, the Commission accepts that customers switching from or to gas tend to do so only infrequently: “Most energy consumers are only infrequently in a position to switch energy forms. During the economic life of their plant or appliances they are unlikely to switch.” {3.87}. The evidence thus suggests that there are customers who, after a decision on energy form is made, cannot change either to or from gas. The decision of a large acquirer of gas services to switch to an alternative energy

¹ For a comprehensive breakdown see: *Submission on Commerce Commission’s Draft Framework Paper of 16 July 2003*, Vector, 20 August 2003, Appendix 1

type, and so forego acquiring the gas services, may have a significant effect on the utilisation of their former supply pipeline. The current uncontrolled regime provides no protection to gas users who cannot switch in the near future against transport price increases aimed at protecting pipeline owners' revenue on assets left underutilised by the loss of a major customer.

2.1.2 Bundled Component Gas Services

The significant component gas services can be summarised as:

- transport of gas² (see 2.3);
- allocation of gas (e.g. metering, reconciliation, see 2.4); and
- non-transport pipeline operations (e.g. use of line-pack, see 2.5).

The report bundles these together with only metering receiving brief consideration as an isolated service. In respect of metering the Commission concludes that "it is appropriate to treat metering as one component of the gas services markets, rather than placing it within a discrete market" {3.30}. While bundling the definition of gas services in this way may be a useful simplification for determining whether control should be applied, it would have undesirable implications when it comes to determining the form of control. Since the nature of each of these components differs, as well as the range of suppliers involved, the eventual control regime must protect both:

- the ability of new entrants to join the market as suppliers of any of the component gas services, and
- the ability to access the market for each component gas service.

The ability to do this will be diminished if control is applied to bundled services. Unbundling these components would allow market forces to be effective in driving efficiencies in those components where competition is possible. Applying control only to those gas services where access is restricted, or where new entrants are hindered, will produce a more efficient outcome than a blanket control of bundled services.

2.2 Un-bundling not part of the counterfactual

Contact is aware that NGC has proposed a degree of unbundling under its new transmission arrangements:

"In relation to service provision, NGCT has to date provided a premium service under the TSA, which has *bundled* a number of services together. It is both necessary and timely to consider whether this arrangement should continue and

² The terms of reference specifically exclude LPG {2.10} even though transporting gas in the form of LPG is the only alternative to transporting gas in pipelines. The inquiry is thus unfortunately limited to considering only a sub-set of this component. Whangaporaoa {3.70} is evidence that LPG can not compete with pipelines at the transmission level, but this conclusion may not be valid for distribution.

whether particular services should be unbundled. At the very least, unbundling services has the benefit of making costs more transparent and allocating these in a more cost reflective manner.”³ [original emphasis]

MDL also proposes a degree of unbundling of its gas services and gas production operation:

“The principle of non-discriminatory open access require that Maui’s management of the Maui Pipeline should be kept at arm’s-length from other affiliated operations upstream or downstream in the value chain. Maui will address this requirement but it may not be justifiable from a cost perspective for as long as throughput volumes of non-Maui gas are relatively low.”⁴

Contact concurs with these sentiments, but believes that the likelihood of unbundling of NGC’s and MDL’s services falls far short of evidencing a progression toward unbundling of all component gas services. In determining whether to impose control, therefore, Contact supports the assessment being based on a counterfactual of bundled services. When and if it comes to determining the form of any control regime, however, that regime should differentiate between services that are or could be unbundled.

2.3 Transport of gas

2.3.1 Transmission

The Commission unbundles the transmission services provided by MDL into two classes: services provided pursuant to the Maui Gas Contract, and future services provided via an open access regime. The Commission’s preliminary view in relation to the services provided by MDL is that “[control of] pipeline services supplied pursuant to the Maui Gas Contract would not be in the interests of acquirers.” {14.79}.

The Commission states:

“In general, the Commission considers that it would not recommend control in respect of services supplied under a long term contract, provided the contract was freely entered into and the market was workably competitive at the time of agreement. In these circumstances a declaration of control over services supplied under contract could have an adverse impact on future contracting, whether for services supplied in that market or in other markets.” {14.78}

The Commission considers that the parties to the Maui Gas Contract had reasonably well-balanced countervailing power. Therefore control of the pipeline services provided under the Maui Gas Contract would not be in the interests of acquirers. Contact agrees with this finding.

With regard to services provided under the Maui open access regime, the Commission considers that MDL provides pipeline services in a market with limited competition and

³ *Future gas transport arrangements, An NGC Transmission Issues Paper*, March 2004, Paragraph 119.

⁴ *Maui Gas Transmission: Explanatory Memorandum*, February 2003, paragraph 14.

therefore that “pipeline services provided under the Maui open access regime should be controlled” {14.85}. Contact agrees with this finding, but, in the case of the services offered by MDL, believes that control must focus on the nature of the service offered as much as the price.

Contact believes the basis that the Commission uses for assessing whether control would be in the interests of acquirers is too narrow. The Commission focuses solely on the level of prices, but there are other aspects of services that may be regulated by control with potential net social benefits. In particular, possible owners might seek to impose terms which are neither economically efficient nor in the interests of users. In this context, MDL’s current proposal for a common carriage regime for gas transmission, rather than contract carriage, is of greatest concern. Reasons for this include (see also 2.7.3):

- Free riders and economic efficiency: Under a common carriage regime, regular users of the pipeline will subsidise short term intermittent users, as short term users will not be contributing to the fixed costs of the pipeline to the same magnitude as regular users. This results in an outcome which is not the most economically efficient.
- Quality of service: At times of congestion, under a common carriage regime all users have their transmission capacity scaled back on a pro-rata basis. This means if an intermittent user causes the congestion, all users, including regular users, bear the cost of the congestion, reducing the quality of the service for regular users.
- Price signals and economic efficiency: Common carriage does not provide price signals in times of congestion on the pipeline. In such events capacity does not necessarily go to the user who values it the most. Under a contract carriage regime with firm capacity rights, shippers who value the transmission capacity less than the prevailing market price will sell that capacity to shippers who value it more, enhancing allocative efficiency. The lack of a price signal also results in muted investment signals, which in turn impacts on dynamic efficiency. Both allocative and dynamic efficiency would be improved by price signals, which are facilitated by contract carriage.
- Lack of certainty will deter investment: Common carriage does not guarantee long term access to the pipeline. There is no contractual commitment on the part of the pipeline owner to make capacity available beyond a day ahead. This puts in jeopardy investment in both downstream projects such as power stations and upstream development of new gas field. Both types of investment are capital intensive. Financiers for both types of investment need to be able to see that future revenue streams are secure and underpinned by robust contracts. However contracts cannot be considered robust if there is no certainty of gas transmission.
- Competition effects: In a related issue, information asymmetry will have competition impacts in sales to end-users. Users of the pipeline will have no certainty of service, which means that upstream new-entrants, wholesalers and retailers will not be able to make sales to end-users that “guarantee” delivery of gas. The owners of the pipeline are also upstream producers of gas, and will have an advantage over other pipeline users in that they can use their superior information and influence to plan ahead with certainty.

Thus, where a gas producer also owns a transmission line, it can structure the pipeline service to maximise the benefits for its own upstream production requirements rather than to provide an efficient stand-alone transmission service that is for the benefit of all acquirers. This will not only result in distributive wealth transfer away from consumers to producers, but will also detrimentally affect economic efficiency, particularly dynamic efficiency.

Section 70(3) of the Commerce Act provides that "different authorisations in respect of prices, revenues, or quality standards for controlled goods or services may be made to meet different circumstances relating to the supply of those goods or services." From this Contact believes the Commission may make terms of services subject to control.

Together, sections 70(1) and (3) of the Commerce Act provide that the Commission may make different authorisations in respect of all or any component of prices, revenues or quality standards to meet different circumstances relating to the supply of controlled goods or services. Therefore, the Commission may make the contractual terms of gas supply services (and therefore type of carriage) subject to control. This can be either done by:

- authorisations as to quality standards; or
- authorisations as to price.

As mentioned above, Contact considers that quality standards would be adversely affected if gas supply services were supplied on a common carriage basis, due to a lack of firm capacity rights under this regime. This would especially be the case for those components of quality standards that relate to guaranteed capacity of gas supply services. This is because guaranteed capacity is of a higher quality standard than uncertain capacity, both in terms of congestion management and the impact on investment in upstream and downstream projects. Therefore, the Commission can make an authorisation as to quality subject to the requirement that a contract carriage regime is implemented.

Similarly, an implicit component of the price that a gas pipeline owner can charge is the nature of carriage that is being charged for. The price of guaranteed capacity would differ from the price of variable capacity. Therefore, as part of authorising a pipeline owner to charge a certain price, the Commission could make this authorisation subject to a certain method of carriage being implemented.

Contact notes that the Australian Productivity Commission is in the process of undertaking a review of gas access arrangements in Australia. This review includes not only an analysis of price levels but also of access regimes. Key points to note coming out of this review include the recommendation for the legal separation of the transmission business from the production, purchase or sale of gas, something that most other countries with developed gas markets has adopted. It also recommends that a tariff should not allow a vertically integrated service provider to set terms and conditions that disadvantage competitors of its associated business in upstream or downstream markets, except to the extent that the cost of providing access to these competitors is higher.

VENCorp has also recently undertaken a review of the Victorian gas market in Australia. It recommends a move away from the current common carriage arrangement, which has similarities with MDL's common carriage regime, to a contract carriage regime. VENCORP states this move would support pipeline development, secure arrangements for investment in gas power stations, and reduce the risks from inconsistency between the Victorian access arrangements and arrangements in other states, which are based on contract carriage. In New Zealand such problems are likely to arise between NGC's contract carriage regime and MDL's proposed common carriage regime.

Under section 52 of the Commerce Act, Contact believes the Commission should consider the type of access regime adopted by a pipeline company, and whether control or regulation of the access arrangement is "necessary or desirable" in the interests of acquirers.

Contact is developing a detailed submission on the issues surrounding MDL's proposed common carriage regime. A copy can be made available to the Commission if so desired.

2.3.2 Distribution

Contact believes the most efficient way of ensuring equal treatment for all acquirers of transport services is for these to be available to all acquirers on the same terms and conditions: that is, that there should be open access for third parties to all pipelines, including by-pass lines. It can be noted in support of this principle that the government has recognised the importance of open access to transmission lines in its policy statement {1.49}. Such open access is not to preclude contractual capacity rights being held by those funding the pipeline construction, as is the case in the proposed Maui access arrangements, so long as such capacity is utilised. It is a common feature of contract carriage mechanisms around the world⁵ that unutilised contracted capacity should be released to those who can utilise it.

The Commission has proposed that by-pass represents a discrete market since it has been limited to the supply of commercial and industrial ("C&I") customers {3.32}. Contact contends that the market for by-pass is limited to C&I customers as they are being targeted for the sale of gas, and by bundling gas energy and gas delivery the by-pass owners can avoid offering the same energy terms to less attractive customers of that gas. By-pass does not represent a discrete market for gas services if not bundled with the gas itself. If open-access was required on by-pass pipelines then Contact believes the end-users they service would not be restricted to those C&I customers whose gas consumption make them attractive customers for "cherry-picking" by gas retailers.

Contact believes the presence of by-pass pipelines is itself an indication of inefficient pricing. As a natural monopoly pipeline owners should be able to provide gas pipeline services at the most efficient price. If a pipeline owner's pricing or and/or access regime

⁵ For instance, Gaz de France, and GasTransportServices of the Netherlands. Un-used capacity does not always have to be released by the holder of the capacity right, but where this is the case, it is reflected in high prices being charged for the capacity right. Non-utilised capacity thus becomes uneconomic. This is the approach adopted by NGC.

presents the opportunity for by-pass pipelines to be constructed, it is clearly not providing the pipeline services in the most economical and efficient way. This reinforces the argument for control of pipeline services.

2.4 Allocation (Metering and Reconciliation) of gas

So long as metering is not bundled with transport services, Contact believes that it is a contestable market. Metering has few of the characteristics of a natural monopoly and there is no evidence that metering is an impediment to customer transfer.

Contact's experience is that restrictions on its ability to compete in this market arise from the actions of pipeline owners who only offer bundled pipeline services and do not allow third parties to provide metering. For example, Powerco imposes a pre-emptive requirement for the use of its meters in new connections. Contact believes that metering should be unbundled from other gas services so that it is exposed to the market forces of competition to allow capture of the efficiency gains of competition. In Auckland and Wellington, retailers frequently utilise independent gas metering but as mentioned above, it is difficult in other areas of the country. Third party metering is allowed and is acceptable in the electricity industry and therefore Contact believes competition to provide metering can work effectively in gas.

There is an added danger that the bundling of metering with transport services in an eventual control regime could exacerbate the current restrictive behaviour of gas distribution companies. This could arise if gas service providers have the risks associated with meters removed by being able to include the costs of meters in their asset base so as to receive a regulatory return.

Similarly, Contact believes that reconciliation should be a contestable service and not bundled with transport for the purposes of control.

2.5 Non-transport Pipeline Operations

With regard to non-transport gas services, the importance of considering not just price but quality of service offering is again highlighted. Some pipeline operations have a significant value to acquirers, but may not be offered to all acquirers even under an open-access regime.

The value of access to capacity in improving allocative efficiency is discussed below (2.7.3). Another example of a component gas service not available to those best able to put a value on it is access to line-pack on an hour-by-hour basis. The use of line-pack to provide flexibility in hourly supply rates would have considerable value to acquirers, but is not offered as a service by NGCT, nor under the proposed Maui access arrangements. Instead, acquirers are limited to a fixed MHQ. To the extent that fixed MHQs prevent acquirers from sculpting flows in a way that best suits their operations, the value of this service (use of line-pack) is not allocated in an efficient manner.

Although the inquiry is limited to the market for gas services, it can be noted that this allocative inefficiency has a flow on effect to the electricity market, as the effect is to force gas based generators to operate at base load, which leads to an inefficient use of other generation feed-stocks, such as coal or water.

2.6 Behaviour of Gas Retailers who also Generate Electricity

It has been suggested by some industry participants that Contact would prefer to put its gas through its power stations, rather than sell it into the retail market. Both the gas and electricity markets are subject to competition and produce competitive price signals. As an integrated energy provider across these two markets, Contact has a portfolio of options as to how to use the gas it acquires on the wholesale market. If electricity customers value gas more highly than gas customers, Contact would be irrational not to respond to such price signals. Contact's actions are merely reflecting the different relative values placed on gas by different users in the gas and electricity markets. It is rational that Contact should put that gas to the use that achieves the highest value. Following competitive price signals in this way leads to an efficient allocation of resources, both in terms of Contact's internal portfolio and in terms of the national economy.

2.7 Measuring Efficiency Gains

Contact agrees with the approach adopted by the Commission to measure efficiency gains. Further to this approach Contact has identified other benefits from the exercise of control, discussed below. However, these additional benefits just reinforce the Commission's findings, and in principle Contact supports the Commission's approach and assessments.

Along with the Commission, Contact finds it necessary to differentiate between:

- the approaches/techniques applied by the Commission to identify the benefits of control; and
- the control methodology that may subsequently be employed by the Commission.

In theory, there should not be a difference as in either case the same underlying inefficiencies are being tested for. However, to Contact the potential detriment is more serious in getting the control regime wrong – rather than in getting the decision to control wrong.⁶

2.7.1 Efficiency Gains through Regulatory Consistency

Application of the concept of allocative efficiency to a consideration of the nature and extent of control *per se* would suggest that there will be benefits to be gained from consistency of any control mechanism both

- between energy delivery mechanisms (i.e. electricity and gas), and

⁶ See Lally (page 43): "... the consequences of judging excess profits to exist when they do not are more severe than the contrary error ..."

- across the value chain in gas.

Even though the mechanisms for delivering energy are diverse (as for instance, overhead wires compared to underground pipelines), and while recognising that the inquiry is focussed on gas services, one consequence of this conclusion must be that where possible competition between energy delivery mechanisms should be fostered. Any eventual control regime for gas services can aid in this through ensuring consistency of approach in:

- determining asset values and returns; and
- transport pricing principles.

2.7.2 Benefits of consistency with control of electricity lines

In assessing the benefits of control, the Commission appears to have used as a comparator a counterfactual that “may be a continuation of the status quo, with the gas pipeline businesses operating under the present form of regulation, which includes information disclosure and an implied threat of control” {2.59}, while recognising “the impact of the [Electricity and Gas Industries] Bill” {2.67}. There is a difference between such a counterfactual and a control regime not noted in the report, which arises from the recognition that a number of major suppliers of gas services are also major suppliers of electricity (transport) services. As such, these suppliers are already subject to control by the Commission under its targeted threshold regime. Under the counterfactual, these suppliers therefore have some ability to allocate activities and costs common to both gas and electricity service delivery in such a way as to minimise the benefits accruing to acquirers. Under a control regime for gas services, so long as the regime is consistent with the targeted threshold regime for electricity lines companies, the potential for such inefficient allocation can be reduced. This represents a benefit to acquirers of both gas services when compared to a status quo counterfactual.

There are other inconsistencies between gas and electricity transport services that limit competition between those mechanisms of delivering energy. For example, on its gas lines, Powerco charges for de-energised periods, but this is not permitted for electricity. Such inconsistencies may not be an issue for the Commerce Commission at this stage, but may need to be considered in setting a form of control that reduces such inefficient differentiation between delivery mechanisms.

2.7.3 Benefits of consistency across the gas value chain

Contact would again like to highlight the recent review of the Victorian gas market by VENCORP, and the recommendation coming from that review that Victoria move away from a common carriage access regime, to a contract carriage regime. One of the reasons for this recommendation is that such a move would reduce the risks associated with the inconsistencies between a common carriage regime in Victoria, and contract carriage regimes in other states of Australia. These same risks are likely to arise between NGC’s contract carriage regime and MDL’s proposed common carriage regime.

The choice of a common carriage regime for third parties benefits the Maui gas producers as it does not separately value transport certainty. Transport certainty is of particular value to new investors in gas production and to new investors in gas use facilities, such as power stations, as it reduces the risks associated with their investment, so reducing the

costs of raising capital. In the absence of the valuation provided by capacity rights, swings in the relative value of gas to different end users can all be captured by gas producers, with no compensation to those whose transport certainty has been lost. A contract carriage regime would enable the value of transport certainty to be allocated efficiently through the development of a secondary market for pipeline capacity.

To prevent gaming of pipeline capacity in a secondary market certain forms of control could be introduced into that market. Contact notes that in the US prices on the secondary market are capped to those on the primary market, except for short term (less than 30 days) transferrals of capacity.

At the other end of the value chain, the bundling of gas with gas services restricts competition between acquirers and providers of gas services when it comes to gas sales to end-users. Where a gas retailer that also owns pipelines has an advantageous purchase price for its gas, and where it is not obliged to offer a gas transport service to third parties on the same terms and conditions it applies to itself, it can use its lower gas cost to cross-subsidise its pipeline operations rather than passing the full benefit on to its customers.

2.7.4 Direct Benefits of Control Understated

In its analysis of the benefits of control as compared to the counterfactual, the Commission has, in Contact's view rightly, included the compliance costs of gas pipeline businesses as direct costs that will ultimately be borne by acquirers. The analysis uses the costs of this inquiry as an estimate of those costs. However, control would have another direct cost benefit to acquirers that can be quantified, as the analysis does not include the benefits of reducing the amounts spent by acquirers under the counterfactual status quo of preparing credible by-pass threats.

Even where by-pass does not eventuate, there are several instances where the threat of by-pass by Contact has resulted in a reduction of prices by the incumbent pipeline owner. This fact is evidence of inefficient pricing in the current market. The costs to Contact of going through the exercise of making a credible by-pass threat to ensure efficient pricing are high. For instance, for a by-pass threat to be credible, Contact is required to commence the environmental consents procedure, as it did in the case of preparing a by-pass alternative to the NGC pipeline supplying Otahuhu. The resource consenting process is undertaken at not inconsiderable cost to the applicant.

As mentioned earlier, the presence of by-pass pipelines is a result of inefficient pricing. Contact believes that if pricing by monopoly pipeline owners was efficient, by-pass would not occur.

2.8 The Commission's Approach

Contact believes the Commission's approach to assessing the need for control, and in the case of control itself, should be governed by certain principles. The transmission company should not be indifferent to changes in demand. ODV valuations should be based on the economic value of the pipeline assets, which in turn is based on utilisation, or demand for the asset. More economic parts of the grid should not be cross-subsidising less economic parts. In assessing whether control is needed, and in the case of control what form that

control should take, there should not be a principle of revenue neutrality on the part of the pipeline owner. This principle is not found in markets that are subject to competition.

2.8.1 Treatment of foreign ownership

In addition to assessing the net benefit to acquirers, as required under the s52 test described above, the Minister has requested that the Commission examine the net public benefits of control. Contact understands that the Commission has interpreted this request to mean the net benefits of control to the New Zealand public. The key difference between the net benefit of control to acquirers and the net benefit of control to the public is that wealth transfers – within the confines of New Zealand – can be ignored in the public benefit test. For instance, any excess returns may be regarded as transfer payments. On the one hand, this constitutes a loss to the acquirers of services. On the other hand it constitutes an equal gain to the providers of these services.

The Commission has however considered the issue of foreign ownership. Making inferences as to the net public benefit of control in circumstances where foreign ownership exists is fraught with difficulty. At the most simple level of analysis, foreign ownership changes the general rule that wealth transfers can be ignored. In this case, excess returns constitute a loss to the acquirers of services but the equivalent gain to the providers of these services may be partly or wholly transferred outside New Zealand. At a more sophisticated level analysis must consider broader economic issues, including the:

- likelihood that control would discourage outright foreign investment in the sector;
- likelihood of reduced acquisition premiums paid by foreign investors;
- benefits to foreign owned acquirers of gas services if control is too “tight”; and
- reinvestment of excess profits in New Zealand.

Whilst the Commission has limited its analysis to the most simple level, it has nonetheless cautioned against the use of the net public benefits test, noting that other factors have not been included in the analysis. In particular, the Commission is concerned that the assessment of net public benefits may be seen as discriminating against foreign ownership. Contact would be similarly concerned if such sentiments were to form the basis of commercial outcomes in New Zealand. Once again, this demonstrates the need for universal control – i.e. a control regime that applies to all gas services providers based on the identified benefit of having controls in place.

Contact agrees with the Commission that the public benefit test is problematic and should not form the basis of a decision on whether control is required.

2.9 The Potential Control Regime

Contact recognises that it is premature to be discussing the control regime in advance of any decision for gas pipeline services to be controlled service in accordance with the Commerce Act 1986. This stance is broadly similar to that adopted by the Commission, although, the Commission has had to make reference to a possible control regime in order to compare the benefits of Control with the counterfactual.

Contact is motivated to support the introduction of control on the basis that it produces efficient, fair and equitable outcomes for all parties, as is typified by markets in the competitive sector. As argued above, whilst fully recognising that the Commission's indications as to a possible gas control regime are not definitive proposals, Contact is concerned that the control regime:

- is focussed on price and not on price and service quality; and
- is applied to bundled gas services, and not to only those component services which could not be exposed to market forces through being made contestable.

In addition, Contact considers that the indicative proposals represent departures from competitive sector outcomes in respect of:

- the regulatory period; and
- determination of excess profits.

At this stage Contact does not consider it appropriate to engage in the quantification of the WACC/CAPM parameters, accepting the parameter values derived by Lally, but noting that it may be necessary to reconsider these values in light of the eventual form of control (if imposed).

2.9.1 The regulatory period

The report argues in favour of a ten year regulatory period (eleven years including the period of control preceding the finalisation of the control regime). At face value, this regulatory period could offer strong incentives for efficiency gains that could be shared with consumers.⁷

Similarly, a lengthy regulatory regime would be expected to provide consumers with significant price certainty. In this regard, Contact notes that acquirers have been subject to considerable price uncertainty through recent price adjustments announced by NGC, whereby NGC's throughput fee increased from 41 to 50 cents/GJ on 1 October 2003, and is to increase from 50 to 61 cents/GJ from 1 October 2004⁸. The regulatory period certainly needs to be long enough to avoid annual price adjustments of this magnitude.

Conversely, Contact is concerned that a too lengthy regulatory period could result in:

- declining investment in the gas pipeline sector; and
- mid-period adjustments (or price spikes in the next regulatory period), which may be necessary to accommodate factors (e.g. demand forecast errors) not evident at the outset.

⁷ On the proviso that the regime was some form of incentive based regulation (e.g. CPI-X).

⁸ Copies of the most recent announcements are attached in the Appendix.

This would significantly disadvantage the whole gas industry. The longer the regulatory period then the greater the need for the regulation to be structured correctly from commencement. Regulation typically results in an imperfect trade-off between allocative efficiency and dynamic efficiency as regulators, including the Commerce Commission, generally err in favour of dynamic efficiency. In the short term, the trade-off, erroneous or otherwise, may not be noticed, but for longer regulatory periods an imperfect balance between allocative and dynamic efficiency may result in a significant bias.

Contact is concerned that it will be impossible to get the balance "sufficiently" right for a ten year regulatory period to work efficiently, due to

- the lack of historic precedents; and
- the sparseness of disclosure data.

Accordingly, there is a risk that a lengthy regulatory period will prejudice economically efficient outcomes.

The risk is heightened by the proposal to exclude Wanganui Gas and Nova gas by-pass lines from the control regime, coupled with the bundling of services. In these circumstances, a merger of controlled and non-controlled operations would give the resulting entity considerable scope to optimise its activities between regulated and un-regulated business units. For instance, it could seek to minimise its risks, by centralising riskier components of its gas services (such as metering) in the regulated business. This would reduce the allocative efficiencies deriving from the control. Clearly, the possibility of such a merger increases with the length of the regulatory period.

Although periodic reviews may be incorporated into the regulatory period, Contact believes that a 5 year control period may be a good compromise between a short regulatory period (3 years) and a long regulatory period (10 years).

2.9.2 Determination of excess profits

Contact submits that the appropriate base for assessing excess returns is: the WACC expressed in real terms applied to an asset base re-valued in accordance with ODV methodology.

There should be no need to include revenue adjustments for revaluation gains/losses in the base. The approach should be forward looking only. In a competitive market and under ODV methodology, which mirrors the outcome of a competitive market, the price for use of those assets will equate to the marginal cost of the assets. Firms with assets purchased at other than the current replacement cost (marginal cost) would:

- realise or record a revaluation gain or loss on the asset; and
- adjust prices to the new entry price level.

The Commission's approach is to suggest that gas services providers may adjust prices to reflect the new entry price level, but at the same time also adjust prices to the extent that they have recorded a revaluation gain or loss on the assets.

Under the Commission's proposals, the purchaser of services is exposed to the risk of either:

- over investment (gold plating) or investment in stranded assets – perhaps due to rash investment decisions by asset owners; or
- under investment or divestment in gas infrastructure, due to the asset owner's potential unanticipated gains stripped away by the regulator.

In the interests of efficient outcomes, and dynamic efficiency, Contact recommends the use of a real WACC on a re-valued asset base to determine excess returns. Where a real WACC on a re-valued asset base is used, revaluation gains/losses should be ignored.

3. RESPONSES TO SPECIFIC QUESTIONS

Table 2: Questions requiring Comment

Q	Question from Draft Report	Contact to Respond?
	Legal Framework	
Q2.1	How should metering be addressed within the inquiry?	Metering should be treated as a separate, contestable gas service. See 2.4
Q2.2	What, if any, other services should be included or excluded from the scope of this inquiry?	Component gas services should be unbundled, and contestable services not subject to control. See 2.1
Q2.3	What, if any, other matters should the Commission take into account when assessing whether control is necessary or desirable ... in the interests of acquirers?	The Commission needs to consider the quality and terms of service as well as the price. See 2.3.1
Q2.4	What, if any, other matters should the Commission consider regarding the issue of foreign ownership of gas pipeline businesses?	Consideration of foreign ownership Is not appropriate See 2.8.1
Q2.5	What other matters, if any, are relevant to a decision on whether control should be introduced?	The Commission should consider the wider benefits of consistency of control regimes across gas and electricity transport services. See 2.7.2
	Competition Analysis	
Q3.1	How should markets be defined to facilitate the competition analysis required by the Inquiry?	Gas supply should not be bundled with gas services. See 2.1.1 Component gas services should be treated separately. See 2.1.2
Q3.2	Having regard to the terms of reference for the Inquiry, is it appropriate to incorporate metering services in the gas services market when the gas service provider also owns the meters?	Metering should not be bundled with other gas services for the purpose of control. See 2.4

Q	Question from Draft Report	Contact to Respond?
Q3.3	Are the market characteristics in the regions served by bypass pipelines sufficiently distinctive to justify placing those regions in a separate geographical market?	Yes, in geographic regions where there are by-pass pipelines this clearly creates different market dynamics. These differences may be even greater where there is third party access to the by-pass pipeline See 2.3.2
Q3.4	Are the market characteristics in the region of the Maui pipeline sufficiently distinctive to justify placing that region in a separate geographical market?	Yes.
Q3.5	How effective is competition for all categories of consumers in the vicinity of bypass networks?	By-pass is limited to specific high-value customers. Competition for all categories of customers would be enhanced if third party access was required so enabling access by all acquirers , including other retailers. See 2.3.2
Q3.6	Is there any evidence to suggest that a new competing pipeline is sufficiently likely in the near term to place an effective competitive constraint on the incumbent?	
Q3.7	What assessments are available of the price elasticity of demand for gas transmission and gas distribution?	
Q3.8	What proportion of the price of delivered gas can be attributed to transmission and to distribution of that gas?	The following data is for Auckland only. The percent of the delivered energy price accounted for by transmission and distribution for the average residential customer is approximately 49% excluding metering. For the average small commercial customer this proportion is approximately 53% and for the large commercial customer approximately 44%, excluding metering.

Q	Question from Draft Report	Contact to Respond?
Q3.9	How significant is the competitive pressure placed on gas transmitters and gas distributors by other forms of delivered energy?	In certain situations there may be competitive pressures from fuel switching, in the main however Contact believes there is not sufficient competitive pressure.
Q3.10	What protection from the use of market power arises from long-term and medium term transmission and distribution contracts?	Long-term contracts only provide significant protection if they are associated with capacity rights. Both the value, and likelihood of entering long-term contracts is lessened by the proposed Maui common carriage regime. See 2.3.1
Q3.11	Are there significant factors affecting the degree of competition in the relevant markets not covered in the Competition Analysis chapter?	The proposed common carriage regime significantly affects the degree of competition for transmission. See 2.3.1
Q3.12	Having regard to all the factors which provide competitive constraints, is there workable or effective competition in the: - market for transmission services between North Taranaki and Huntly? - market for transmission services in the rest of the North Island? - market for distribution services? - market for distribution services in bypass regions?	 No. No. No. No. This would require open access to by-pass lines. See 2.3.2
	Assessment Principles	
Q4.1	Are there any additional matters the Commission should consider in the assessment of allocatively efficient prices?	Contract carriage with a secondary market for capacity allows for the efficient allocation of the value of transport certainty. See 2.3.1

Q	Question from Draft Report	Contact to Respond?
Q4.2	Can the avoidable cost methodology provide scope for the over recovery of common costs? If so, how should the Commission deal with this matter for this Inquiry?	
Q4.3	Is there any additional evidence the Commission should consider in the assessment of service quality issues for gas pipeline businesses?	Service quality, and the terms under which a service is provided, are critical elements of the necessary control regime. See 2.3.1
Q4.4	Is the NPV=0 principle adopted for this Inquiry an appropriate standard for the assessment of returns of businesses facing limited competition?	
Q4.5	Are there any additional matters the Commission should consider in the application of the NPV=0 principle?	
Q4.6	Are there any additional matters the Commission should consider in the assessment of the productive efficiency of gas pipeline businesses?	
Q4.7	Are there any additional matters the Commission should consider in the assessment of the dynamic efficiency of gas pipeline businesses?	Service quality and the terms of the provision of a service. The impact of contract carriage, as opposed to common carriage, on dynamic efficiency See 2.3.1
Q4.8	Are there any additional matters the Commission should consider in determining its assessment principles for gas pipeline businesses?	
	Assessment Approach	
Q5.1	What are the additional matters the Commission should consider in the measurement of allocative inefficiency, productive efficiency, dynamic efficiency, and/or excess returns?	

Q	Question from Draft Report	Contact to Respond?
Q5.2	Which of the costs measured by the Commission can/can not be assumed to ultimately fall on acquirers?	
Q5.3	Are there any additional matters the Commission should consider in the measurement of the direct costs of control?	The Commission should also consider the costs to acquirers under the counterfactual of preparing credible by-pass threats to ensure efficient prices. See 2.7.4
Q5.4	Are there any additional matters the Commission should consider in determining the level of excess returns and allocative inefficiencies that would be unrecoverable by control?	
Q5.5	Are there any additional matters the Commission should consider in the measurement of the indirect costs in terms of productive inefficiency from control?	
Q5.6	Are there any additional matters the Commission should consider in the measurement of the indirect costs of control in terms of service quality?	
Q5.7	Are there any additional matters the Commission should consider in the measurement of the indirect costs of control in terms of new investment?	
Q5.8	Are there any additional variable and/or sensitivity tests that the Commission should consider during its assessment approach of gas pipeline businesses?	
	Asset Valuation	
Q6.1	Are there any additional matters the Commission should consider regarding its position that an opportunity cost approach is inappropriate for the assessment of gas pipeline businesses when assets are sunk?	

Q	Question from Draft Report	Contact to Respond?
Q6.2	Are there any additional sources of historic cost asset values of gas pipeline businesses that the Commission should explore?	
Q6.3	Are there any additional matters the Commission should consider regarding the valuation of easements for gas pipeline businesses?	
Q6.4	Are there any additional matters the Commission should consider in determining the appropriate asset valuation approach for gas pipeline businesses?	
Weighted Average Cost of Capital		
Q7.1	Are there any other matters the Commission should consider regarding the various components of WACC?	
Q7.2	Should the 75th percentile of the WACC range be used for the final report?	
Q7.3	Are there any other matters the Commission should consider in the calculation of WACC?	
Comparative Benchmarking		
Q8.1	What additional information could be used to improve this comparative benchmarking analysis?	
NGC Holdings Ltd – Transmission (NGCT)		
Q9.1	What material factors, if any exist, affecting the level of competition faced by NGCT have not been taken into account in the Commission’s analysis?	
Q9.2	Does NGCT face workable or effective competition in the markets in which it provides gas services?	No.
Q9.3	What additional sensitivities, if any, should the Commission test for its final report?	

Q	Question from Draft Report	Contact to Respond?
Q9.4	What percentile of the WACC range should be used for the final recommendation?	
Q9.5	What adjustment to the level of common costs, if any, should be made for the final recommendation?	
NGC Holding Ltd – Distribution (NGCD)		
Q10.1	What material factors, if any, affecting the level of competition faced by NGCD have not been taken into account in the Commission’s analysis?	
Q10.2	Does NGCD face workable or effective competition in the markets in which it provides gas services?	
Q10.3	What additional sensitivities, if any, should the Commission test for its final report?	
Q10.4	What percentile of the WACC range should be used for the final recommendation?	
Q10.5	What adjustment to the level of common costs, if any, should be made for the final recommendation?	
Powerco Limited (Powerco)		
Q11.1	What material factors, if any, affecting the level of competition faced by Powerco have not been taken into account in the Commission’s analysis?	
Q11.2	Does Powerco face workable or effective competition in the markets in which it provides gas services?	
Q11.3	What additional sensitivities, if any, should the Commission test for its final report?	
Q11.4	What percentile of the WACC range should be used for the final recommendation?	
Q11.5	What adjustment to the level of common costs, if any, should be made for the final recommendation?	

Q	Question from Draft Report	Contact to Respond?
	Vector Limited (Vector)	
Q12.1	What material factors, if any, affecting the level of competition faced by Vector have not been taken into account in the Commission's analysis?	
Q12.2	Does Vector face workable or effective competition in the markets in which it provides gas services?	
Q12.3	What additional sensitivities, if any, should the Commission test for its final report?	
Q12.4	What percentile of the WACC range should be used for the final recommendation?	
Q12.5	What adjustment to the level of common costs, if any, should be made for the final recommendation?	
	Wanganui Gas Limited (WGL)	
Q13.1	What material factors, if any, affecting the level of competition faced by WGL have not been taken into account in the Commission's analysis?	
Q13.2	Does WGL face workable or effective competition in the markets in which it provides gas services?	
Q13.3	What additional sensitivities, if any, should the Commission test for its final report?	
Q13.4	What percentile of the WACC range should be used for the final recommendation?	
	Maui Development Limited (MDL)	

Q	Question from Draft Report	Contact to Respond?
Q14.1	What material factors, if any, affecting the level of competition faced by MDL have not been taken into account in the Commission's analysis?	The Maui partners dominance in gas production. The access regime has been designed to benefit Maui gas producers. See 2.3.1
Q14.2	Does MDL face workable or effective competition in the markets in which it provides gas services?	No.
Nova Gas Limited (Nova Gas)		
Q15.1	Q15.1 What material factors, if any, affecting the level of competition faced by Nova Gas have not been taken into account in the Commission's analysis?	The Commission's analysis does not reflect the lack of open access arrangements, and the bundling of gas supply with the supply of gas services, on Nova's by-pass lines. See 2.3.2
Q15.2	Does Nova Gas face workable or effective competition in the markets in which it provides gas services?	No.
Taranaki Pipelines		
Q16.1	Is the proposed change in use of the LTS pipeline sufficient reason to exclude the pipeline from the Inquiry?	No. Contact believes that the proposed use of the pipeline will mean it will be important for transport of non-specification gas from a number of fields to gas processing facilities. It will be the only pipeline that is not dedicated to a specific field supplying that transport service. Contact believes there should be open access to that service. Contact believes that pipeline should not be excluded from the inquiry.

Q	Question from Draft Report	Contact to Respond?
Q16.2	Should Frankley Road pipeline be regarded as an integral part of NGCT's network for the purposes of the Inquiry?	Yes. Contact supports the Commission's view. The Frankley Road to Kapuni pipeline is an essential part of the North Island gas transport system supplying gas to users such as the TCC power station and Petrochem. In the future it is also likely to be increasingly important for transporting specification gas from Taranaki fields to the Maui Pipeline and to NGC's southern pipeline. Contact believes this pipeline should be included in the Commission's inquiry
Q16.3	Is it in the interests of acquirers or suppliers of gas services provided by the Kapuni to Hawera pipeline for those services to be controlled?	Contact believes this pipeline is dedicated to a single use and it can be excluded from the Commission's inquiry
Q16.4	Is it in the interests of acquirers or suppliers of gas services provided by the pipeline running from the McKee Production Station to Faull Road for those services to be controlled?	Contact believes this pipeline is dedicated to a single use and that other parties are unlikely to be interested in accessing this short length pipeline. Contact believes this pipeline can be excluded from the Commission's inquiry.
Q16.5	Is it in the interests of acquirers or suppliers of gas services provided by Swift's pipelines for those services to be controlled?	This is potentially an important cross-Taranaki pipeline that could compete with NGC's Frankley Road to Kapuni pipeline. Swift has obligations to deliver gas through that pipeline under an agreement that bundles gas and transport services. Contact believes to the extent of that service it is not necessary to include the pipeline in the Commission's inquiry. However, to the extent the pipeline is available for providing services to other users it should be included in the Commission's inquiry.

Q	Question from Draft Report	Contact to Respond?
Q16.6	Is it in the interests of acquirers or suppliers of gas services provided by Westech's pipeline for those services to be controlled?	Contact believes because of the short length of this pipeline and its dedicated use it can be excluded from the Commission's inquiry.