



MAJOR ELECTRICITY USERS' GROUP

2 July 2004

Mr Paolo Ryan
Gas Pipeline Inquiry
Commerce Commission
PO Box 2351
WELLINGTON

By email to gaspipelinesinquiry@comcom.govt.nz

Dear Paolo

Submission on Gas Control Inquiry Draft Report

1. This is a submission by the Major Electricity Users' Group (MEUG) on 5 questions raised in the Commerce Commission "Gas Control Inquiry Draft Report" of 21 May 2004.

Q 2.4 Foreign ownership

What, if any other matters, should the Commission consider regarding the issue of foreign ownership of gas pipeline businesses?

2. In paragraph 17.24 the Commission's draft recommendation states (underlining by MEUG):

"The Commission notes that the results of the net public benefits assessment for NGCT and NGCD are significantly affected by foreign ownership. The Commission reiterates its view that treating businesses differently because of foreign ownership differences only, creates potential costs not addressed in this analysis. For this reason the Commission cautions the use of the net public benefits analysis."

3. MEUG suggest that the costs of differentiating between New Zealand and overseas owned enterprises will be more than just "potential," they will be "real." A bias against foreign investment will be noticed by the market and will alter investor perceptions of New Zealand and hence sovereign risk. This will affect the entire economy not just the gas sector. Estimating this chilling effect on investment is difficult but MEUG suggest rather than just "caution" the government, the Commission take a much stronger recommendation against use of the net public benefits assessment where foreign ownership is treated differently.

Q 5.3 Regulator costs recovered by taxation or levy and resultant welfare treatment

Are there any additional matters the Commission should consider in the measurement of the direct costs of control?

4. In paragraph 5.64 the Commission adds 20% to the estimated costs of the regulator to reflect the marginal welfare loss of additional taxation to cover the regulators direct costs. MEUG believe this should be reconsidered for two reasons:
 - a) The current practice is for industry specific regulatory costs to be recovered by the Commerce Commission as a levy on that industry. The same practice is proposed for the Electricity Commission. It is therefore unlikely the costs of the Commerce Commission controlling gas businesses would be funded from the Consolidated Fund and therefore that an additional amount for the marginal welfare loss of additional taxation is appropriate.
 - b) If the Commission does wish to assess such second order impacts, then MEUG suggest a much more relevant issue is the flow-on effect to end gas consumer investment decisions with and without control. For example without control gas users will have certainty that future gas transport prices will be higher than with control but will have uncertainty about how high the monopolist intends to lift those prices. The additional cost and uncertainty may be sufficient to trigger inefficient levels of input substitution, deter otherwise efficient new investment or hasten the closure of existing gas consumption businesses that from a national benefit perspective should remain operating. These dynamic efficiency effects have not been assessed in the draft report but are much more material issues than any marginal welfare losses due to additional taxation to cover the costs of the regulator.

Q 7.1 Asset beta

Are there other matters the Commission should consider regarding the various components of WACC?

5. The first sentence of paragraph 7.64 states (underlining by MEUG),
"The Commission adopted an asset beta of 0.4 for electricity lines businesses and 0.5 for the airfield operations."
6. MEUG believe no asset beta has been adopted for electricity line businesses in terms of the Part 4A threshold-investigation-control regime for Electricity Lines Businesses (ELB). The asset beta of 0.4 was proposed in a report by Professor Martin Lally in a report dated 4 August 2003 attached to a report from the Commission titled "*Regulation of ELB Targeted Control Regime - Draft Assessment and Inquiry Guidelines (Process and Analytical Framework)*" of 7 August 2003. In submissions on the draft guidelines MEUG raised significant questions about the proposed range of asset beta for ELB that if correct would lead to an asset beta below 0.2 (refer MEUG submission "*Comment on asset beta recommended in Lally paper*," 1 October 2003). As far as MEUG are aware the draft guidelines including the proposed asset beta for ELB of 0.4 have never been finalised. If MEUG comments on the proposed asset beta for ELB are adopted by the Commission, then the gas pipeline asset beta will also be much lower than 0.4 as proposed in the draft Gas Inquiry report.
7. The Commission said it placed little reliance on the observed 3-year average asset beta for NZ gas business of 0.2 (paragraph 7.61). MEUG note:
 - a) The first reason why the Commission place little reliance on the observed NZ asset beta is "*the short period of analysis*." MEUG suggest 3 years data is not insignificant and if the Commission believes a longer series would be useful; then an analysis including the 18 months data since January 2003 should be undertaken.
 - b) The second reason why the Commission place little reliance on the observed NZ asset beta is "*the businesses had activities other than gas transmission or distribution*." For NGC all of its other businesses would have had a higher asset beta

relative to the gas pipeline business and for Powerco and UnitedNetworks their other businesses would have had a mixture of higher asset beta and lower asset beta (the latter only for electricity line businesses). On balance MEUG suggest the observed NZ asset beta may well fairly reflect the market view of a gas pipeline business and further investigation is warranted.

Q 7.2 which percentile of WACC range?

Should the 75th percentile of the WACC range be used for the final report?

8. Paragraph 7.79 states,

“The Commission also proposes to take the 75th percentile of the WACC range (ie half way point between the High WACC and Mid Point of WACC) in the final report, in order to judge whether there are net benefits to acquirers.”

9. In contrast to the extensive consideration of the range of values for each component of WACC, there was no analysis as to why the 75th percentile range was more appropriate than the 50th or 25th percentiles. Standing back and asking which percentile should be used; MEUG suggest the answer must be the 50th. Any shift from the 50th percentile midpoint is a deliberate bias and, in the view of MEUG, the Commission has not demonstrated any reason why a bias should be used or if there should be a bias; that the best mechanism is by using WACC.

10. It could be that the Commission has a particular concern that the costs and risks of regulation may be understated. If that is the case then the best approach is to load specific costs to reflect that specific risk rather than using an arbitrary 75th percentile range on WACC that affects all the benefit and cost flows.

Q 14.1 Post Maui contract pipeline access

What material factors, if any, affecting the level of competition faced by MDL have not been taken into account in the Commission's analysis?

11. MEUG support the Commission statements regarding access to the Maui pipeline over and above residual Maui contract obligations that end in 2009. In particular MEUG agree:

- a) *“Regarding the services to be provided under the anticipated Maui open access regime, the Commission considers that those services are likely to have a critical role to play in promoting the efficient delivery of gas, especially for electricity generation.”*
(Paragraph 14.80)
- b) *“The current open access regime proposed by Maui in 2003 states that the regime will provide transport services at a reasonable price consistent with the methodologies and rates of return available to other NZ network owners. If Maui was to set prices using the methodologies and current rates of return of the other gas pipeline businesses it is apparent that the building block principles set out above would not be satisfied and that control is likely to be in the interests of acquirers.”*
(Paragraph 14.83)
- c) *“Based on both the pricing provisions in the open access regime proposed by Maui in 2003 and the potential for further delay in open access being introduced, the Commission's preliminary view is that it would be in the interests of acquirers that gas services supplied by MDL, under the Maui open access regime, be controlled.”*
(Paragraph 14.84)

12. Earlier this year MDL revised their proposed Maui pipeline open access Information Memorandum. However the changes are cosmetic and the arguments set out by the Commission above are still valid. As some of the Maui pipeline owners are also participants in the competitive upstream and downstream markets, the risk of anti-competitive opportunities and behaviour arising is very high. It is important that both the aggregate level of charges relating to access to the Maui gas pipeline and the structure of those prices are controlled to ensure efficient and pro-competitive outcomes should MDL fail to significantly change its Information Memorandum.

Yours sincerely



Ralph Matthes
Executive Director