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Ben Gerritsen
General Manager Commercial and Regulation
First Gas Limited
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Dear Ben

Submission on the GTAC Emerging Views Paper

Introduction

1. This is Vector Limited's (Vector) submission on the consultation paper released by First Gas, *Gas Transmission Access Code Development: Emerging Views on Detailed Design of Access Products, Pricing, Balancing and Allocation*, dated May 2017.

2. We generally support First Gas's pricing and balancing proposals, but have serious concerns about its proposed access products which are likely to create unnecessary complexity for the single gas transmission access code (GTAC). We set out below our views on those proposals and provide some suggestions to meet the GTAC objectives of 'keeping things simple' and 'enabling the use of gas'.

3. No part of this submission is confidential. Vector's contact person for this submission is:

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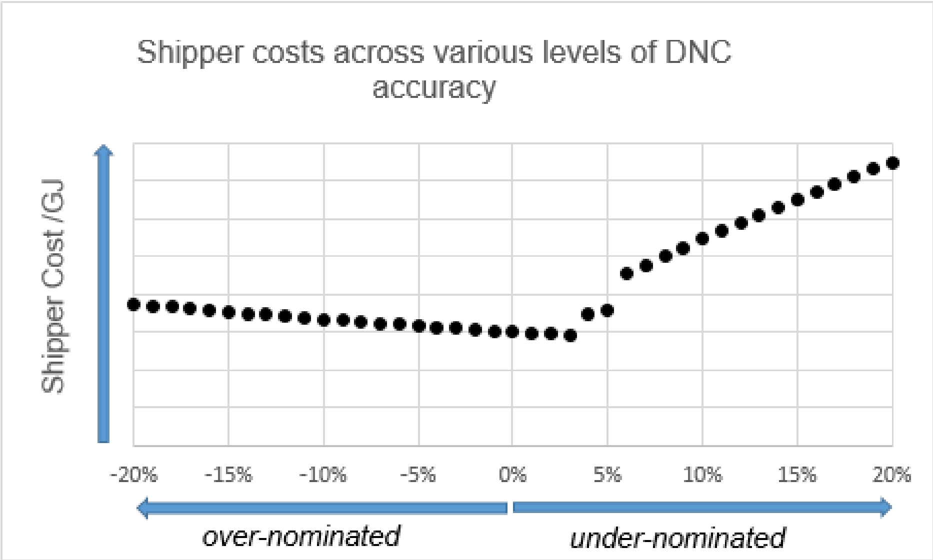
Access products

Daily nominated capacity

4. In our view, the proposed daily nominated capacity (DNC) would create more transactions as shippers would now be required to forecast two nominations (instead of one) for each customer. One of the nominations would be our anticipated customer demand adjusted to address our running imbalance position, and the other would be the DNC. This fails to meet the GTAC objective of minimising complexity and transaction costs.

5. A consequence of imposing daily and hourly overruns on the DNC is that shippers will be incentivised to focus on avoiding the overrun costs rather than providing First Gas with robust information on the demand we anticipate from our customers and therefore their capacity requirements.

6. The chart below shows the impact of the proposed DNC framework, in its current form, on the accuracy of shippers' DNCs.



7. The chart shows that:

- the lowest cost is where a shipper under-nominates by 3%;

- a prudent shipper would recognise that it is likely that the delivered quantity would be different from what is expected. Assuming an equal chance of over- or under-nomination occurring, a shipper would move to the left side of the cost line (willing to over-nominate) to avoid being exposed to the steeper transport costs that are incurred when a shipper under-nominates. The extent to which a shipper elects to over-nominate will be influenced by its appetite for risk; and

- with nominations at a delivery point, rather than a zone, over-nomination by shippers is amplified across all delivery points, potentially creating a significant difference between anticipated flows and booked capacity. If overruns were at a zonal level, potential 'unders and overs' that occur on delivery points within the same zone would be factored in by shippers and potentially reduce the extent to which a shipper over-nominates.

8. To minimise complexity and transaction/overhead costs, we propose various options that First Gas could implement:

- ensure that the incentives for accurate DNCs are double sided, enabling the determination of anticipated customers' demand and DNC to be made in the same nomination; or

- remove both daily and hourly overruns and introduce a daily mismatch charge alongside the running mismatch charge − a framework closer to MPOC arrangements; or

- create capacity zones for non-direct connect delivery points with the ability to remove a capacity zone and require DNCs for these delivery points when First Gas believes there is or is likely to be capacity constraint. This would simplify the process up to the point where greater granularity of information is required.

Priority rights

9. We remain concerned with the greater complexity and uncertainty that priority rights (PRs) will generate, and the increased risks we face around the following:

- *Information asymmetry*

  It would be highly challenging for shippers and customers to put a value on PRs, given they do not have up-to-date information on current and emerging congestion that First Gas possesses. While Vector accepts that information on congestion may be available via First Gas's information disclosure obligations, assessing the risk of congestion is not a simple and costless process.

  Around 83% of the volume of gas transported in New Zealand goes to direct connect customers. It is therefore First Gas that will have the most accurate information about likely increases in capacity requirements, not shippers and other customers. Furthermore, it means 83% of gas transported will not be subject to a competitive bidding process as there is only one end user. If there were to be multiple bidders on a direct connect gas gate, we would be concerned as it provides a lever for a shipper/retailer to use against the end user in contract negotiations.

  The six-month validity of PRs means those who hold them, or intend to bid for them at future auctions, can assess their value only for a very limited timeframe.

  In addition, Vector does not agree that the traded price for PRs should be confidential as this goes against the desired outcome of greater pricing transparency. We suggest that traded prices for PRs between shippers be published.

- *Risk transfer*

  Customers who economically do not (or cannot) value PRs with sufficient confidence to protect themselves in times of congestion may view gas as a less attractive fuel source. We agree that PRs provide strong price signals to First Gas to invest in additional capacity but during that process of creating additional capacity, the industry would lose customers. This will not promote the use of gas.

  The risks associated with the lumpy nature of congestion are effectively being placed on shippers and customers, including direct connect customers, who have no tools to deal with those constraints while carrying unlimited liability for continuing to use gas. This effectively transfers risks from First Gas, who is the party best placed to determine and manage congestion, to customers via their shippers.

- *Security of supply*

  We believe the highest marginal value from the creation of PRs would accrue to mass market customers, whose access to capacity cannot be constrained (unless there is no gas at all), for example, under the curtailment arrangements of the *Gas (Critical Contingency Management) Regulations 2008* (CCM Regulations). We suggest that First Gas consider the implications of the CCM Regulations on the value of PRs.

10. To address complexity that is likely to be generated by the above issues, we recommend that First Gas:

    - only auction PRs on zones or delivery points where First Gas believes there is congestion, or where congestion is anticipated (or reasonably anticipated). First Gas is the party best placed to determine congestion and should do so in practice, rather than shippers and customers;

    - allow direct connect customers to purchase PRs and then assign those PRs to shippers. This could be achieved via an interconnection agreement (ICA) between First Gas and the direct connect customer;

    - develop and implement a demand management response scheme that provides price signals for scarcity and a physical solution in times of actual congestion, rather than relying solely on the CCM Regulations;

    - place a cap on the unlimited loss currently associated with overruns; and

    - adopt the marginal price of the last block of PR at an auction as the price for all PRs of that auction (Figure 1 in the consultation paper) – for simplicity, especially as this revenue is returned to shippers and eventually customers. Price signals would still be available to First Gas and shippers will be paying the same price for the same priority.

11. First Gas has stated that PRs are designed so that customers and/or shippers who place a higher value on capacity rights can acquire firm capacity by paying a premium. While this approach is appropriate for a competitive market, we do not consider it to be the case for the monopoly gas transmission services market. We expect First Gas to apply a neutral and non-discriminatory policy regarding the allocation of firm capacity rights. It is likely that customers or shippers with considerably more resources will acquire most of the PRs, potentially displacing smaller customers or shippers from the market. This will not promote the use of gas.

12. Following advice from First Gas that PRs are not "financial products" under the *Financial Markets Conduct Act 2013*, emailed to Shippers on 20 June 2017, we suggest that the GTAC include a provision confirming this to be the case, to avoid any doubt in the future. We also suggest that First Gas seek advice on whether PRs are financial arrangements under other legislation such as the *Financial Reporting Act 2013* and *Income Tax Act 2007*, and if so, what this implies for the relevant parties.

Pricing

13. We generally support First Gas's pricing proposals.

14. As mentioned above, direct connect customers face the risk of hourly overrun charges, with unlimited risk for those who do not hold PRs. We suggest that First Gas develop tools for direct connect customers to manage such risks. First Gas could consider:

    - increasing the number of nomination cycles. For example, a direct connect customer may only operate for a certain number of hours a day and does not need to make nominations for an entire day; and/or

    - allowing hourly profiled nominations.

15. The proposed monthly credits to shippers from PR fees will significantly increase transaction costs and complexity for shippers. We suggest that First Gas amend its proposal so these credits are paid annually, rather than monthly.

Balancing and allocation

16. We generally support First Gas's park and loan and balancing regime proposals. We suggest that First Gas develop measures to ensure the transparency of these mechanisms to market participants.

17. First Gas's initial allocation proposal is likely to be less accurate than allocation under D+1 (i.e. the variance between daily and interim allocations under GTAC is expected to be larger).

18. The wash up of balancing incentive charges and the gas under GTAC would also need to be much more sophisticated than under D+1 to minimise incentives for gaming.

19. We propose that First Gas implement the recommendations of the GIC and the Downstream Allocation Working Group (DAWG), which will focus on allocating cost to causers.

Further engagements

20. We are happy to further discuss our submission and views with First Gas during the drafting of the GTAC over the coming months.

Yours sincerely

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