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15 November 2011

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Dear Ian

Submission on the MPOC Change Request of 13 October 2011
– Back to Back Balancing

1. Vector Limited ("Vector") welcomes the opportunity to make this submission on Maui Development Limited's ("MDL") proposed changes to the Maui Pipeline Operating Code ("MPOC Change Request"), dated 13 October 2011. No part of this submission is confidential and we are happy for it to be publicly released.

2. Since the transmission pipeline balancing issue gained prominence five years ago, Vector has been committed to seeking the improvement of New Zealand's transmission balancing arrangements through mechanisms that are more consistent with the 'causer pays' principle, and provide for better integration between the Maui and Vector transmission systems. We believe this approach would lead to more efficient and fairer, hence more enduring, balancing arrangements.

3. While the Change Request seeks to introduce a particular framework, Vector notes the wider context within which this proposal is being considered, which MDL also notes in its *MPOC Balancing Change Request 2011 Consultation Document*, dated July 2011. Pipeline balancing has been a long-standing issue for industry participants and the Gas Industry Company ("GIC"), and efforts to resolve this matter have so far failed because of the inability of the industry to reconcile competing commercial drivers.

4. As assessed in Appendix A, in Vector's view, the Change Request would not meet many elements of the GIC's evaluation criteria, predicated on the objectives of the Gas Act 1992 and the Government Policy Statement for Gas Governance 2008.

5. Nevertheless, Vector is prepared to support the Change Request subject to the adoption of additional clauses that we propose in this submission. Our view is informed by the specific proposals in the Change Request, the evolving views of stakeholders and the GIC, and our desire to avoid the exhaustive and costly balancing resolution processes industry participants experienced in recent years.

Conditional support for the Change Request

6. MDL proposes to introduce into the MPOC a back to back balancing framework, where Welded Parties are cashed out based on their end of Day positions whenever a balancing gas transaction has occurred. The key elements of the proposed framework are the:

   a) removal of Imbalance Limit Overrun Notices ("ILONs");

   b) unbundling of the combined points;

   c) modification of Incentive Pool Mechanisms;

   d) reduction of Running Operational Imbalance Limit tolerances; and

   e) introduction of a flat peaking charge contingent on gas purchases or low line pack, to reflect the scarcity of Intra-Day flexibility.

7. Vector believes the more focused back to back balancing framework in the current Change Request represents some improvements to current arrangements, including efficiency gains. However, we believe the Change Request will not pass muster when assessed against the GPS objectives. We discuss this further in Appendix A.

8. The Change Request, in its current form, also creates a material adverse effect on Vector's transmission pipeline business, and the compatibility of MDL and Vector's open access regimes. As the TP Welded Party, Vector is invoiced by MDL for the balancing costs, and could not pass much of them on under the current Vector Transmission Code ("VTC"). Even if Vector's arrangements were aligned with MDL's proposal, peaking costs would not necessarily be borne by causers due to inherent downstream data limitations.

9. Bearing in mind the above adverse effect on Vector's transmission pipeline business, we nevertheless recognise the potential efficiency gains from some of the proposed changes. Vector is therefore prepared, subject to the following

conditions being agreed, to work with MDL to implement modified balancing arrangements[1]:

a) The inclusion in the current Change Request (or another Change Request that is effective from the same date as the Change Request), clauses which:

- explicitly give Vector the right to pay balancing costs to MDL only to the extent to which Vector is paid by the causers of the balancing cost (to expressly reflect current practices and the position under the MPOC); and

- acknowledge that all balancing costs are caused by the users of the pipeline downstream of the TP Welded Points, and not the TP Welded Party.

b) The removal of the peaking mechanism.

c) The implementation of the Change Request must be contingent on:

- the implementation of a VTC change request effective from the same date as the Change Request to ensure that the MDL and Vector open access regimes remain compatible at all times; and

- the successful implementation of changes to Non-Code Agreements effective from the same date as the Change Request to ensure that the MDL and Vector open access regimes remain compatible at all times.

10. We believe adopting the above conditions would provide Vector the comfort that these would lead to balancing arrangements that are more integrated across the Maui and Vector transmission systems, and more consistent with a 'causer pays' approach.

11. We note that MDL expresses its "willingness to work together with Vector in coordinating implementation of any changes...". We expect, therefore, that MDL will work towards the successful resolution of the proposals underpinning Vector's conditional support for this rule change.

[1] Vector has some more specific drafting comments on the Change Request which would need to be addressed in any implementation, for example, the removal of balancing call and put price from the information generally available on the MDL IX. Clarification would also be required whether clause 3A.4(iii) will mean that MDL will open the balancing market to all Shippers.

Impact on Vector's transmission pipeline business

12. We outline below the material adverse impact of the Change Request on Vector's transmission pipeline business. Overall, it reduces Vector's rights and increases its obligations and costs under the MPOC, including (but not limited to) the following:

    a) The Change Request removes Vector's right to recover imbalance and peaking costs under the VTC and Non-Code Agreements, as it is not contingent on Vector successfully amending the VTC and Non-Code Agreements to reflect the proposed amendments to the MPOC. Based on 2010 and 2011 data, this increased cost could amount to $1.5 million per year.

    b) It increases Vector's exposure to peaking costs. Based on 2010 and 2011 data, peaking costs could increase seven fold based on the existing level. Although peaking costs may be recovered from Vector's Shippers under the VTC and Non-Code Agreements, the inherent limitations of accurately allocating these costs to causers, and based on experience to date, in Vector's view would expose Vector to more disputes by its Shippers and exacerbate its role as financial intermediary.

    c) The Change Request almost guarantees that MDL will over-recover balancing costs each year to the detriment of Vector by approximately $500,000 per year. This is because MDL will either double recover in circumstances where there is a balancing cost and a peaking charge, or will recover peaking charges when it has not incurred a balancing cost. MDL states that any over-recovery will be refunded back to its Shippers via its Tariff 2. However, this over-recovery/redistribution mechanism dilutes the purported aim of targeting balancing costs to causers and at the same time increases Vector's exposure to disputes.

    d) The Change Request removes Vector's (and consequently Vector's Shippers') right to correct an imbalance position during the ILON Period (which is a key mechanism for Vector to manage its exposure to balancing costs) but retains MDL's right to set standard operating procedures ("SOPs"), which determine the extent of these balancing costs.

       MDL bases much of its justification for the revised balancing mechanisms on the ERGEG principles, one of which is:

> **Frequency of balance**: A balancing period that reflects the level of flexibility available to participants to mitigate their risks and manage their positions.[2]

If the SOP was amended to require the pipeline to be balanced daily, Vector and its Shippers would have no mechanism under the MPOC to challenge the content of the SOP and would be faced with significant balancing costs in the order of $20 million per year.

e) The Change Request also removes Vector's right to combined tolerances for imbalance and for peaking at the Rotowaro, Pirongia, and Pokuru Welded Points, which would materially increase the incidence of balancing costs at each of these points.

f) The Change Request further removes Vector's right to make Balancing Gas nominations and the right to use a "Post Intra-Day Cycle" for such nominations. This removes a tool for Vector to provide an independent balancing service on its transmission system if it chose to do so.

13. In addition to the above direct impacts, Vector would also incur legal and internal costs associated with attempts to amend the VTC and Non-Code Agreements, and attempts to resolve disputes arising from the Change Request.

14. We are working the above issues through with MDL under the parties' Interconnection Agreement ("ICA").

Closing comment

15. Vector wishes to see balancing arrangements that are fairer and more efficient, and therefore enduring. We are prepared to support the Change Request subject to MDL's agreement with our conditions and co-ordination with Vector in their implementation. We have formally raised, under the provisions of the parties' ICA, the material adverse effect the Change Request would cause on Vector's transmission system. MDL and Vector are working through a process to attempt to resolve this.

16. Vector's view is informed by our and stakeholders' desire to avoid another protracted process of developing new balancing arrangements. We therefore look forward to engaging not only with MDL but also with the GIC and relevant parties to progress Vector's proposal above.

17. While we will attempt to reach an agreement with MDL to progress the Change Request, the GIC should not prematurely close the door on other balancing

[2] http://gasindustry.co.nz/sites/default/files/u254/appendix_i_-_consultation_document.pdf, p23

options. To better gauge industry's response and willingness to engage in relation to our conditional support, we suggest that the GIC conduct a cross-submission process or a similar form of consultation, following this Change Request submission process.

18. If you have any questions, or require further information, please contact Luz Rose on 04 803 9051 or Luz.Rose@vector.co.nz.

Kind regards

Bruce Girdwood
Manager Regulatory Affairs

Appendix A: The Change Request assessed against the GIC's Evaluation Criteria

1. The GIC's Draft Recommendation on the 17 December 2009 MPOC Change Request, released in May 2010, developed a set of criteria "as a logical exposition of the Gas Act and Government Policy Statement on Gas Governance (the GPS) objectives in the context of balancing". The criteria were divided into three categories:

    a) efficiency;

    b) (overhead and transaction) costs; and

    c) governance.

2. We discuss at a high level below why the Change Request would not meet many elements of the above criteria.

Efficiency

<u>Productive efficiency</u>

3. Improvements in productive efficiency will be achieved when and where gas is supplied at least cost, competition is promoted, and gas is purchased only when, and to the extent, necessary.

4. Vector recognises that while the Change Request will enable some efficiency improvements, competition (that would place downward pressure on costs) is not promoted as the market is not opened up to parties not directly connected to the Maui Pipeline.

5. The Change Request does not guarantee that gas is purchased only when necessary as the thresholds are in the SOPs, not in the MPOC, and can be changed without consultation. MDL's ability to retain title to any unallocated call gas also does not guarantee it will be at a minimum cost.

<u>Allocative efficiency</u>

6. Allocative efficiency implies that the 'right' amount of service is provided to the right users, arrangements ensure a common price for all equivalent balancing gas, and users have a choice of either self-balancing or using residual balancing services provided by the Balancing Operator.

7. We believe there will be no significant improvements to allocative efficiency as a result of the Change Request. In fact, it could be worse as the removal of the

ILONs reduces opportunities to self-balance. We consider the following statement by the GIC in its May 2010 paper remains valid:

> ...while the proposed arrangements are an improvement, they are not as efficient as they could be. We are concerned the provision of operational gas, such as compressor fuel and UFG, are covered by an operating instruction rather than in the code.

8. The Change Request removes Vector's (and consequently Vector's Shippers') right to correct an imbalance position during the ILON Period, and therefore reduces the ability to self-balance.

<u>Security</u>

9. The GIC considers security is maintained or enhanced if Line Pack remains within the limits necessary to support an uninterrupted transport service, transport is secure whenever Line Pack is within thresholds, and the number of times Line Pack is outside of these thresholds is minimised.

10. Vector does not see the Change Request enabling any improvements in relation to security. We also note that while thresholds are set by MDL in the SOPs, users are not consulted on the level of service security provided.

<u>User risks</u>

11. Risks to users might be reduced through improved self-balancing, ensuring balancing gas is sourced from an open market that maximises available capacity, and arrangements that allow balancing prices to be moderated or costs socialised.

12. Vector does not believe the Change Request will minimise user risks. We consider that the GIC's statement below (in its May 2010 paper) remains valid:

> The proposal gives no notice of a cash-out price, no ability to hedge the price, and has no limits on BGX prices. These conditions together mean a user could be cashed out for any market clearing price without warning the price is high. Some users cannot fully balance because of lack of information (for example, users supplying to the mass market). These users could face an unacceptable cost risk. This result is theoretically possible under the current situation—it might occur where the price is changed to a very high amount at seven days' notice. Some parties have little practical ability to manage the cash-out risk. The proposed arrangement, however, makes the issue more extreme.

13. We further note that there is a very limited market where balancing gas can be sourced.

Costs (Overhead and Transaction Costs)

Agreement costs

14. These costs include costs associated in deciding which features to include in an option, developing the policy for implementing the features, and implementing the policy. Vector considers most of these are sunk costs in the context of this Change Request.

Implementation costs

15. These include costs related to OATIS and other IT changes, the development of SOPs, and organisational change. MDL has not indicated, and should therefore advise stakeholders, of the likely magnitude of these costs.

Operating costs

16. These would include costs in dealing with the complexity of the balancing mechanisms, and the organisational separation of balancing and transport. We believe the Change Request would not significantly affect these costs.

Governance

Transparency

17. Greater transparency is achieved when all stakeholders understand the actions of the Balancing Operator and their resulting balancing charges and risks.

18. Vector considers the GIC's statement on transparency (May 2010 paper) remains valid:

> Gas Industry Co considers the recognition of the difference between operational gas and Balancing Gas is also an improvement. However we are disappointed there is little transparency on how the Balancing Operator makes this separation in practice.

Adaptability

19. This involves adaptability in the assessment, agreement, and implementation of future proposed changes, including how deadlocks are broken. We do not see how the Change Request affects current adaptability.

Enforcement

20. This requires the proper enforcement of rights and obligations, and allows for the quick resolution of disputed breaches. The Change Request's impact is neutral in this regard.

Balance

21. Balance requires arrangements that recognise the interests of all stakeholders, and ensure costs and benefits are allocated fairly and efficiently.

22. We agree with the GIC's statement in its May 2010 paper that the "deletion of Vector's preferential rights to transport gas may disadvantage it". As indicated in this submission, the Change Request increases Vector's obligations and costs under the MPOC.

Stability

23. Stability could be indicated by the extent to which changes are driven by external parties. Stability, or perceived stability, is important in encouraging efficient investment and reducing the costs of operation.

24. While approval of the Change Request, in its current form, could provide some short-term 'stability', or the perception of stability, its inherent unfairness (ie increasing the risk exposure of other parties) would not create stability in the long term.