

The Issues of Open Access Gas Transmission

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Abstract

Whether or not pipeline owners offer priority right to capacity depends on what their customers want and the operational and administrative practicalities of the situation. In reality there are few pure contract carriers or common carriers. It is only a matter of degree. Some pipeline owners contract mostly for priority supply, others provide it only occasionally.

The benefit of defining and selling capacity rights is that secondary market trading then becomes possible. Such inter-company trading is only beginning in New Zealand. Natural Gas Corporation (NGC) Transmission has opened a capacity trading page on the Internet to assist secondary market buyers and sellers getting in touch with each other.

It is also early days for New Zealand's light handed regulatory regime. The failures of heavy handed regulation are widely understood and acknowledged. Shortcomings of light handed regulation are only now being identified. One weakness is the poor definition of the ODV methodology for utility network valuation. Efforts are being made to develop standards for the application of ODV which will apply across the whole gas industry.

A range of other issues relating to the unbundling of gas trading and transportation services remain on the agenda, and most will be dealt with in the year ahead.

Introduction

Today I want to talk about some aspects of open access that I know you are concerned about and some matters which I think we will need to look out for in the future.

I will talk about common carriage and contract carriage, about pricing, about offering a wider choice of transport services and about the management and control of the transmission system.

Contract Carriage and Common Carriage

There has been a lot of discussion, particularly in the Gas House forum, over the differences between contract and common carriage. Early versions of the Gas House Gas Pipeline Access Code defined a "Common Carrier" transport system as one which does not provide for the reservation of capacity.

The significance of the distinction was that the Code required pipeline owners who did not offer Common Carriage to provide particular, narrowly defined services.

The Code no longer makes this global distinction between access regimes. Instead, and wisely in my view, it recognises that any pipeline owner may offer priority service from time to time.

There is a widespread misconception that pipeline access regimes are either entirely contract carriage or entirely common carriage. As Gas House has now recognised, this is not so. Pipeline owners commonly offer both services. It is only a matter of degree.

What determines the mix of arrangements a pipeline owner will offer is partly determined by customer preferences and partly by the practicalities of selling priority rights to capacity.

Let me give you an example. Suppose I am a food processor with a need for process steam. My raw materials are perishable so I need a certain energy supply. One choice open to me is to go dual-fuel.

Then, if my gas supply is interrupted I can then use, say, fuel oil. But providing this degree of back up will be costly. I would prefer to have a contract with my gas supplier which gave me a high degree of certainty that gas will be available and not interrupted.

I know that there are other customers who also use the gas pipeline which supplies me. But I think that their operations are more flexible and that they value certainty of supply less than I do. So, armed with this information, I go along to my supplier and say "let me contract for a priority supply of gas, I can pay more than other customers because I value security of supply more than they do".

What should happen in this situation? Well, I think that we all might agree here that there is only one sensible outcome. The supplier should provide priority supply at a premium price.

Would it matter if the supplying pipeline has been declared a Common Carrier pipeline? Surely even then the best outcome would be to offer the service.

Of course the pipeline owner may be pig headed (some are) and say "No, I am a Common Carrier and do not give priority rights to service." Well, as the customer I would then have to invest in fuel oil facilities as back up or make a deal with my neighbour so that, if capacity does get tight, he will shut down so that I have enough gas to carry on processing. In other words I will give up on the pig headed pipeline owner and get what I want by other means.

And, at the extreme, I might decide that I can get all the security I need by using fuel oil alone. That would cut out the pig headed pipeline owner and benefit the more customer friendly oil companies.

My point is that the pipeline owner should not refuse to deal. And generally I think that pipeline owners are not stupid enough to refuse to offer a premium service at a premium price. So even on systems declared Common Carrier, deals are commonly done to give customers what they want, and rightly so.

Similarly, pipelines which are not Common Carrier frequently provide interruptible services where there is no priority right to capacity.

In practice transmission pipelines are generally contract carriers and distribution companies are generally common carriers. This is because transmission pipelines generally serve larger customers who often require certainty of supply. Distribution pipelines serve smaller customers to whom supply is less critical. Also, it is easier for a transmission pipeline to define and sell capacity rights. Capacity on distribution networks is a very elusive measure and it would be very difficult to manage priority supply among many thousands of domestic customers.

But, as Gas House has concluded, there is no need to be dogmatic. Any pipeline may offer priority rights to capacity from time to time. Some do so as a rule and some as the exception.

Secondary Trading

Those pipelines which do offer capacity rights can bring their customers other benefits. It is only where rights to capacity are defined that secondary trading in capacity becomes possible. Where secondary trading is possible it brings the benefit that prices are free to be set between willing buyers and willing sellers. This price discovery process improves allocative efficiency. When capacity is constrained its price on the secondary market will be high. When it is unconstrained its price will be low. It also gives customers more choice.

In my opinion the jury is still out on the effectiveness of the secondary market in transmission capacity in New Zealand. Only a handful of intercompany trades have so far taken place on the secondary market. This is not too surprising because it is only since last October that most of the old bundled utility contracts ("the 1980 contracts") were replaced. And on some parts of the system - Wellington and Hawke's Bay - transition arrangements will be in place for another year.

It is not necessary or desirable for NGC Transmission to be involved in the secondary market. However, it has opened a capacity trading page on the web to help buyers and sellers to get in touch with each other. The way this works is that a party interested in buying or selling capacity notifies NGC Transmission. NGC Transmission will then post this information on the capacity trading page. Other parties can then look up the page and, if they are interested in making a trade they can contact the party buying or selling the capacity.

So the whole thrust of the contract carriage regime is to encourage customers to manage their capacity requirements. It is, if you like, the access regime for grown-ups. It provides rights but with those rights go responsibilities. The responsibility to plan ahead and reserve capacity according to need. The responsibility to balance gas going into the pipeline with gas being taken out of the pipeline. The responsibility to deal on the secondary market.

This kind of regime doesn't suit everyone. When interstate pipelines in the United States were first pushed towards open access contract carriage they argued that supply failures would result. They claimed that they were in the best position to manage supply and demand and by unbundling transmission rights customers would be at the mercy of inept traders who lacked the skills to manage capacity. They were wrong.

Even though the United States open access regime is orders of magnitude more complicated than our own, traders have acquired the necessary skills, capacity is managed efficiently, there is a dynamic secondary market, a futures market and fierce competition for customers.

Even so, who's to say that what is right for the United States is right for New Zealand? There are many differences between New Zealand and the United States. Some of you will say that one of the most significant differences is our lack of price regulation. Right? Well, not quite, and that brings me to the next topic I would like to comment on.

Light Handed Regulation

Here in New Zealand the energy supply infrastructures are subject to rate of return regulation just as in the United States. You might be surprised to hear this but it is true. The difference is that these businesses in New Zealand are ultimately judged not by an industry specific regulator but by their peers, customers, competitors and Government - according to their profitability as disclosed through the Information Disclosure regime.

This is not a "bright-line" policy.

There is no mandated rate of return beyond which line owners will become subject to discipline. But public statements have been made on occasion as to what accounting rate of profit may be acceptable. And certain companies have already been censured by the Minister for being consistently out of line.

Many of you think this process is imperfect. I agree with you. I am particularly concerned that the ODV methodology is not sufficiently formalised to allow unbiased comparisons between these businesses. This is a problem which must be addressed and NGC is taking the initiative.

We are currently working with consultants to develop a more codified basis for ODV valuation in the gas industry. In due course we will seek industry comment on the resulting proposals.

But let's not lose sight of the reasons why New Zealand has opted for a light handed regulatory regime. There is world wide recognition of the very unsatisfactory results produced by heavy handed regulation. It just doesn't give customers what they want.

Too often regulation is only about setting maximum prices and minimum levels of service. In other words it tries to protect customers from truly awful service but offers no incentive to provide good, let alone excellent, service. This results in demoralised companies who waste their energy pampering to the wishes of earnest and well-intentioned regulatory bureaucracies. A long way from the ideal of efficient businesses focused on customer needs and offering innovative services

So let's recognise that there are problems in the current regulatory regime - ODV is one, I think the one dimensional focus on rate of return is another - but let's not fall for quick fixes. Heavy handed price regulation is the way of the past, not the way of the future.

On the topic of price, I would like to give a short update on NGC Transmission's current pricing method.

Pricing Method

First, we need to remember that NGC's current pricing method developed through a lengthy process. You may remember that as far back as 1992 NGC opened the debate on access and pricing with a paper entitled "A Customer Guide to Transmission Services". A further public document, "The Pricing of Transmission Services", was released in 1993 and an industry conference was held in 1994 to discuss the key issues. Several public documents were released later in that year, by both Enerco and NGC, debating various aspects of access and pricing.

The pricing method which resulted from this process - the Optimised System Cost Allocation method - has now been in place for four years. Although the method is generally serving well, some problems have emerged. One problem is that capacity reservation fees are quite volatile. We have prevented extreme results by capping the absolute price and the rate of price change but volatility continues to be of concern to customers as we are looking for a more effective solution.

More Unfinished Business

The unbundling of sales and transport has raised a number of operational matters which still need to be addressed. For example I believe there is still a degree of mis-understanding in the industry over how responsibilities for odourisation are met. Contingency planning also requires some attention. We may need to formalise the controls which transporters need to exercise, perhaps giving flow control orders some legal status as is the case in the United States.

In addition, there is some vagueness in the relationship between transmitter and distributor. Currently there is no contractual arrangement which defines this relationship although co-operation is clearly required.

Conclusion

There is still a range of access issues which the industry must work through. On the positive side, the gas industry has so far avoided the bitter and protracted confrontations of the telecommunication industry. It has also made significant progress. The old contractual relationships between NGC and its utility customers - the 1980 contracts - have been replaced by unbundled contracts.

Most importantly, customer choice has improved. Customers now have a range of potential suppliers and those suppliers are successfully contracting for transmission and distribution services.

On the regulatory side, work is underway to standardise the application of ODV principles in the gas industry.

On pricing, further developments can be expected to reduce the volatility of transmission prices.

Finally, some outstanding industry issues arising from industry restructuring require attention. NGC plans a number of initiatives to open debate on these matters during the coming year. We hope you will work with us to resolve these.

Author

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