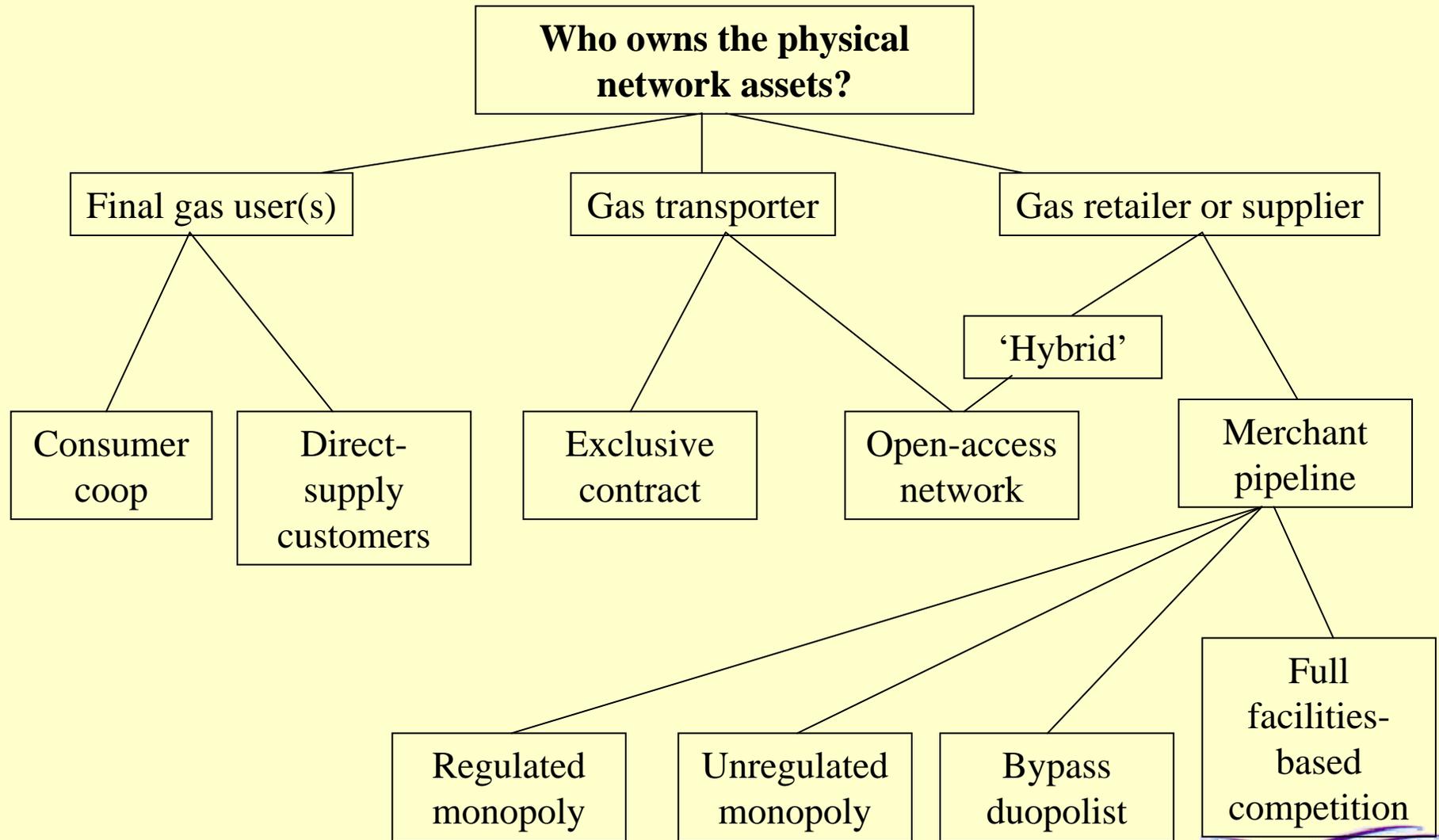


Gas Governance Arrangements and Private Networks

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Taxonomy

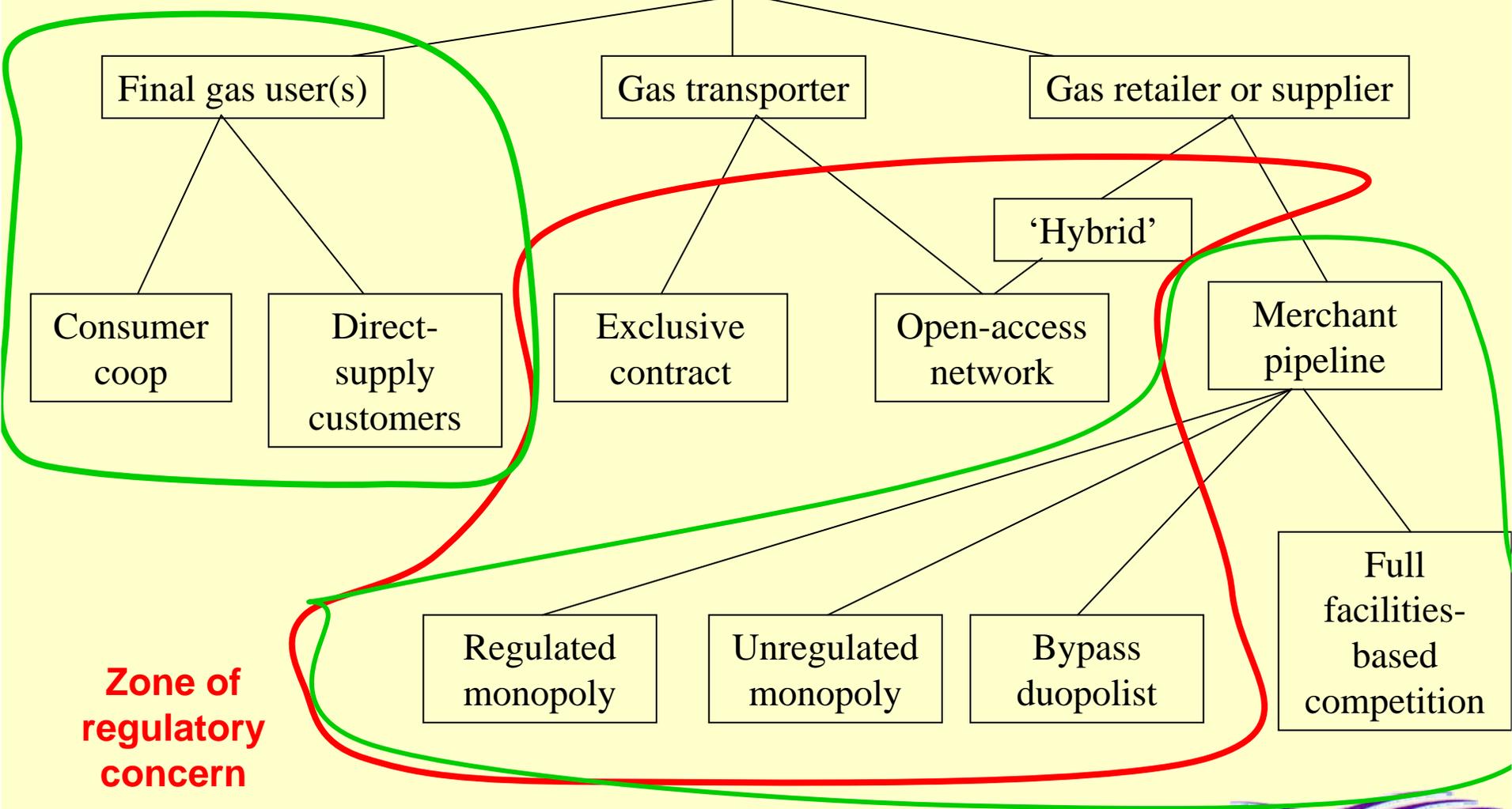


Definition

For the purposes of this report, a “private network” is defined as a pipeline system owned and operated by, and for the exclusive benefit of, a party or consortium which owns all gas transported on the system. The exclusion of third parties from use of the facility is central to its characterisation as private.

Who owns the physical network assets?

Private systems



Zone of regulatory concern

Taxonomy

	Type	Subtype	Are structural limitations on downstream competition of concern?	Is there a case for independently-enforced operating rules e.g. reconciliation ?	Does monitoring of industry-wide performance require detailed information disclosure?
Owned/operated by distributors	Open access monopoly network	Transporter	No	Yes	Yes
		Hybrid	Yes	Yes	Yes
	Private merchant monopoly or duopoly with no open access		Yes	Possibly	Yes
	Duopoly networks with open access on at least one		Ideally no	Yes	Yes
	Full facilities-based competition amongst numerous merchant networks		No	No	Yes
Owned/operated by final gas users	Consumer cooperative facilities connected to upstream distribution or transmission systems		No	No	No
	Direct-supply customers		No	No	No

The four Hilmer tests

- I. *Access to the facility in question is essential to permit effective competition in a downstream or upstream activity;*
- II. *The making of the declaration [requiring open access] is in the public interest, having regard to:
 - (a) *the significance of the industry in the national economy; and*
 - (b) *the expected impact of effective competition in that industry on national competitiveness.**
- III. *The legitimate interests of the owner of the facility must be protected through the imposition of an access fee and other terms and conditions that are fair and reasonable, including recognition of the owner's current and potential future requirements for the capacity of the facility.*
- IV. *The creation of such a right must have been recommended by an independent and expert body.*

Private status the default in NZ; but the Hilmer tests have applied to some operators at two of the five industry levels

- gas-gathering networks which connect wellheads to processing plants;
- gas processing facilities;

- high-pressure transmission networks running from the outlet flange at processing plants to gate stations adjacent to major load centres;
- distribution networks moving gas at lower pressure from the gate station to the customer meter;

- the final leg, downstream of the customer meter within the customer premises, where various gas-using equipment is connected.

Hilmer and bypass

- Full facilities-based competition lies outside the Hilmer tests
- Regulated open access should in theory rule out facilities-based competition
- In practice, bypass is triggered by imperfections of open access
- A single bypass entry creates duopoly which means neither facility is strictly “essential”

Bypass does create competitive pressure and so a case for exemption from open access

- MED's response 1999 re information disclosure:

“98. We are aware of a view in the industry that Nova Gas should be subject to information disclosure. The key judgment is whether Nova Gas's activities have any natural monopoly characteristics, or market dominance. If they do not there is no regulatory justification for Nova Gas to be subject to the Regulations.

99. Nova Gas's pipelines can (with minor exceptions) be categorised as providing bypass competition to other pipeline networks (and therefore are not natural monopolies). Its other activities are also contestable (gas collection and production, and gas retailing). The Ministry therefore considers that Nova Gas does not have market dominance, and that it should not be subject to the Regulations.”

Bypass does create competitive pressure and so a case for exemption from open access

- Commerce Commission's response 2003:

“[T]he immediate areas where a bypass operator is competing with the incumbent have been placed in a discrete market. In these markets the Commission considers that there is strong evidence of vigorous competition for industrial and commercial customers.”

“The [Commerce] Commission considers that Nova Gas faces workable or effective competition in the market where it provides gas services. That is, competition is not limited in this market. The requirement in s 52(a) of the Commerce Act is therefore not satisfied.”

Three problems with the Commission position

- Competition is not really “not limited” in a bypass duopoly market
- Facilities duplication is wasteful of scarce resources and hence in principle undesirable on productive efficiency grounds; but may be desirable for dynamic efficiency
- Bypass entry tends to cherry-pick large customers, with negative spillovers for other customers

Suggested modification of Hilmer

- In a duopoly neither network is strictly essential on its own
- Competitive retail supply requires at least one network to be open
- In the long run, the responsibility for open access should fall wherever it is most efficiently performed
- In the short run, bypass entrants deserve some time-limited exemption to bring competitive pressures on retail prices while recouping entry costs
- This modification to contestability theory is sensible in the present of large fixed entry costs

Implications for regulatory exemptions

- Bypass entrants should have time-limited freedom to operate as merchant networks
- In the longer run a judgement call is needed on whether to impose open-access obligations
- The wider the scope and larger the scale of the bypass, the weaker the case for exemption
- Geographical extent and time elapsed since entry are relevant matters to take into account

Tests in considering exemption requests

- A first step would be to identify the reasons for allowing the network to retain its private status in the first place.
- Central test: will the exemption strengthen or weaken the benefits which flow to gas users and/or the wider economy from the private status of the network?
- Second test: will exemption weaken or strengthen the credibility and effectiveness of the regulatory framework?

Areas of regulation under the Gas Act 1992

- There are more differences between merchant and customer-owned private systems in terms of applicability of the listed issues, than between open-access and merchant networks;
- Of 33 issues listed in Table 2, 28 are clearly applicable to open-access networks, 29 to merchant distributors, and only nine to customer-owned private systems.
- Hence customer-owned systems are the first candidates for exemptions
- Gas safety regulations are the only set that apply universally
- Information disclosure requirements apply very widely because of the need for an industry-wide data base for regulatory purposes
- In Table 3, of the seven issue areas there is no generalised in-principle prospect of exemption is shown for open access networks, one for merchant networks in bypass markets, and two for a merchant network that has been allowed a monopoly in its local market.

	Direct-supply customer (distribution function internalised by the gas-user)	Consumer cooperative network sharing customer-owned connection to upstream point of connection	Competing merchant pipelines (full or workable facilities-based competition)	Merchant distributor with local monopoly	Merchant distributor in a bypass duopoly market	Open access network or networks
Issue:	Subject to regulation?					
Gas safety regulations	Yes	Yes	Yes	Yes	Yes	Yes
Reconciliation amongst multiple retailers	No	No	No	No	No	Yes
Gas balancing and accounting for UFG to central industry body or regulator	No	No	Unclear	Yes	Yes	Yes
Information disclosure aimed to empower customers (overcome information asymmetries)	No	No	No	Yes	Yes	Yes
Information disclosure and recording for purposes of monitoring of overall market	Unclear – depends on nature of information required	Yes	Yes	Yes	Yes	Yes
Detailed metering records of individual customers provided (or available) to central registry to facilitate switching and reconciliation	No	Probably not, but would need regular review	No	No, unless competition is likely in future	Yes	Yes
Standard	No	Probably	Probably	Yes	Yes	Yes

Table 3 pp.29-30

Principles re bypass operators

- Bypass systems typically raise the level of competitive market discipline. Some degree of exemption from sharing in the common costs of regulation across the wider market may be an appropriate form of such a reward.
- Because bypass operators succeed and survive on their price-competitiveness, the costs of price-cap regulation will generally not need to be incurred with respect to those systems so long as they remain the “underdogs” in their competition with the local open-access system. Applications for exemption from such regulation ought to be treated sympathetically.
- Given its competitive incentive to price its bundled service keenly in order to gain and hold market share, the bypass supplier generally need not be subjected to detailed regulation of the structure of its retail tariff.
- Cherry-picking can restrict enjoyment of the full benefits of enhanced competition to a favoured group of customers with the power to play off competing suppliers. Any regulatory universal service obligation should apply.

Principles re bypass operators cont.

- Exemption from bearing a share of the overall costs of achieving regulatory objectives is an incentive to engage in rent-seeking behaviour, which can be corrosive of overall market efficiency and fairness and of the integrity of the industry governance framework itself.
- There is a strong principled case for ensuring that customers of a bypass network are fully free to switch supplier at the termination of each contract, and are not trapped into contract renewal by anti-competitive provisions such as automatic roll-over of contracts
- Rules and regulations which require the posting of standard contract terms and conditions, including clear exit rights for customers, are therefore especially relevant to bypass systems because of their strong incentive to obstruct switching. In general no exemptions from such rules ought to be available.

Principles re bypass operators cont

- In the long run, allowing perennial private-network status to bypass operators may not be sustainable or desirable, and the option of a future transition to open-access status should always be kept open. This means that in principle, any exemption from rules and regulations prescribing access terms and conditions for third parties should be for a limited time only, and subject to revocation with due notice.
- Rules which require the calculation and disclosure of UFG on private as well as open-access networks can have important efficiency and customer-protection roles, and exemption from such rules should in general not be available for merchant systems.
- Disincentives to customer switching will exist if onerous terms and conditions are applied to customer connection, disconnection and reconnection. Exemption from rules and regulations governing these are undesirable.

Principles re bypass operators cont

- Availability of each customer's meter history is potentially important in ensuring efficient switching of customers between competing networks. Merchant systems should be denied exemption from any regulatory requirements to maintain detailed customer consumption records, and should be required to make those records instantly available at the time any customer makes a switch.
- Bypass operators are full industry participants and are an integral part of the overall industry. Effective regulatory oversight, and reduction of information asymmetries facing customers, require a substantial degree of transparency to prevail. There should be no presumption that "private network" status confers any privileged right to confidentiality of information required by the industry body or its agents to achieve their objectives.

Conclusion 1

- The analysis in this paper has identified only one or two individual areas of the governance arrangements where exemption for merchant distributors could be granted as a matter of general principle. In the great bulk of cases, the benefits of exemption would be secured at the expense of some degree of effectiveness in the overall regulatory framework and/or of market efficiency. This suggests that sweeping exemptions ought not to be available to “industry participants” so long as the gas distribution sector remains an arena of limited competition. A merchant distributor in a bypass or monopoly situation ought not to be granted a general exemption from the switching or reconciliation rules.

Conclusion 2

- The key distinction in the legislation is not between “private” and “not private”, but between gas network operators which are “industry participants” and those which are not. The latter lie, by default, outside the regulatory framework established under the Gas Act. In general, customer-owned distribution facilities (including the distribution function implicitly internalised by direct-supply gas users) lie outside the regulatory boundary, while all facilities owned and/or used by gas suppliers selling at retail lie within the boundary.

Conclusion 3

- Downstream competition and fair-trading issues arise primarily with those networks where ownership and control lies with a party other than the final customer. Customer-owned distribution facilities dedicated to the use of the customer or consortium of customers that owns the facility can in principle be exempted from regulation other than for safety. Merchant pipelines, broadly, can not.

Conclusion 4

- Reconciliation arrangements come closest to meeting the criteria for generalised exemption of merchant networks, given the absence of an immediate need for physical reconciliation on a network with only one user.
- Having reconciliation provisions and procedures in place makes it feasible for a private network to be switched seamlessly to open access; a merchant network might exploit an exemption from reconciliation rules to construct obstacles to being declared open-access at a later date.
- The compliance costs to the private network owner of sustaining a redundant reconciliation apparatus would represent a deadweight burden from a static economic point of view, but from a longer-run perspective could be a legitimate share of the cost of constructing and maintaining a uniform industry-wide regime.
- Measurement and recording of UFG makes sense across all distribution systems other than those owned by customers.

Conclusion 5

- Customer-owned systems, and merchant distributors disciplined by full facilities-based competition (which is not realistically likely to emerge), could be granted some general exemptions from regulatory oversight without prejudice to the current objectives of government policy and industry governance.
- The essence of direct supply is internalisation within the gas user's operation of the distribution function – a decision to make rather than buy this service.

Conclusion 6

- Bypass networks have been allowed private status to date, and have secured exemption from regulation on the basis that they are a pro-competitive force in the industry. This provides time-limited grounds for exemption from some regulations while the new entrant establishes its market share and recovers its entry costs, but does not warrant perpetual exemptions.

Conclusion 7

- Of 33 areas identified in Section 43 of the Gas Act 1992 where rules and/or regulations may be made, 28 apply to open-access distribution networks and 29 to merchant pipelines, with 24 areas applying to both. There is no dramatic distinction between the two such as might provide *a priori* grounds for granting exemptions to bypass operators.

Conclusion 8

- Bypass markets are a duopoly, not a monopoly, situation. They require a re-thinking of the “essential facilities doctrine” that underpinned the move to open access in the 1990s. Under duopoly conditions, at least one of the two networks must be open-access to achieve the Government’s policy objectives; but neither pipeline is ‘essential’ on its own. Simply allowing a new-entrant network to free-ride on a general regulatory exemption is not generally wise beyond the time-limited post-entry regulatory holiday

Conclusion 9

- Given the benefits of ensuring that, for example, the central registry holds comprehensive industry-wide data (rather than just data from open access networks); that customers enjoy protection in respect of key provisions in their contracts, especially relating to freedom to switch at expiry of each contract term; that detailed metering information be the property of the customers on both types of network and available to the central registry in order to facilitate switching; that UFG information disclosure be required of all types of networks to facilitate benchmarking and underpin competitive incentives for accurate metering of final customers; and that basic protection against unfair trade practices is available to all retail customers regardless of the status of their supplier, the onus of proof must lie firmly with the applicant for any exemption.

Conclusion 10

- To some extent the right to operate as a merchant network is a privilege in an industry in which other competing distributors have been subjected to structural reform in pursuit of competition objectives.

Conclusion 11

- The mere fact that a private network is bringing competitive pressure to bear in a restricted market segment conveys no presumption of a right to be exempted from regulations or rules directed to wider purposes at the level of the gas market as a whole.

Conclusion 12

- Any exemptions granted ought to be able to be revoked if at any time evidence emerged of strategic behaviour, or of changed circumstances which render the exemption(s) counter-productive from the standpoint of the objectives set out in the Government Policy Statement and the Gas Industry Company strategic plan. Perennial exemptions which convert to *de facto* property rights are not advisable.

Conclusion 13

- The industry-wide monitoring of performance that is required of the Gas Industry Company requires inclusion of all industry-participant networks in the information disclosure procedures as a general principle. Information disclosure should report, for all networks whether open-access or private, the general operating parameters (capacity, pipeline length, number of customers, etc), and data on throughput volumes and UFG.

Conclusion 14

- Customer meter data should be regarded as property of the customer, not the supplier, and should move with the customer.

Summary points 1

- Any regulatory regime should be as simple, transparent and uniform as possible. The broad purposes of regulation can easily become subverted by a rent-seeking quest for exemptions by market participants. Differential treatment of networks opens the prospect that the regulatory arrangements themselves may be “gamed” for private advantage.

Summary points 2

- A “private network” is here defined as a pipeline system owned and operated by, and for the exclusive benefit of, a party or consortium which owns all gas transported on the system. The exclusion of third parties from use of the facility is central to its characterisation as private

Summary points 3

- The clearest case for pragmatic exemption of a merchant network from regulatory oversight relates to reconciliation, because the operational need for independent reconciliation disappears when a network is utilised by only a sole gas retailer rather than several competitors. Merchant pipelines can be provisionally exempted from regulations regarding retailer access to pipes and meters, and procedures for resolving disputes amongst third-party users of pipelines. Other aspects of the reconciliation rules, however, are best applied industry-wide without exemptions which discriminate in favour of merchant operators.

Summary points 4

- The contribution of a bypass network to bringing competitive pressure to bear on incumbent(s) is a relevant matter to be taken into consideration in deciding whether to recommend an exemption from particular rules or regulations.
- The mere fact that a private network is bringing competitive pressure to bear in a restricted market segment conveys no presumption of a right to be exempted from regulations or rules directed to wider purposes at the level of the gas market as a whole.

Summary points 5

- Private merchant distributors should not be exempt from regulations specifying standard terms and conditions for retail supply contracts, particularly provisions aiming to protect the positions of low-income customers, and/or to ensure that customers are fully free to switch supplier at the termination of each contract

Summary points 7

- Because bypass operators succeed and survive on their price-competitiveness, the costs of price-cap regulation will generally not need to be incurred with respect to those systems so long as they remain the “underdogs” in their competition with the local open-access system.
- The Commerce Commission’s control regime, however, has not addressed adequately the price spillovers from bypass markets to the wider population of gas customers

Summary points 8

- All industry participants, private or otherwise, should have to participate in providing information necessary to enable the central registry to compile accurate industry-wide statistics and to monitor the efficient operation of the gas supply chain. There is no presumption that “private network” status confers a privileged right to confidentiality of information

Summary points 9

- Private industry participants should be covered by regulatory requirements to maintain detailed customer meter records in a format compatible with that used by the industry body's central registry, and should be required to make those records instantly available at the time any customer makes a switch to a competing supplier.
- The common costs of operating the Switching Rules should ideally be borne by industry participants as a whole.

Summary points 10

- Exemption from reporting UFG should in general not be available for merchant pipelines, notwithstanding the absence of multiple system users.