

Gas Sector Governance Interim Report



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Background

Natural gas generates 14% of New Zealand's electricity and 22% of its energy and is a major input into petrochemicals and industrial processes. The gas industry operates under a co-regulatory model. The Gas Industry Company Limited (GIC) is the 'industry body' under Part 4A of the Gas Act 1992 (Gas Act). The GIC is currently responsible for seeking voluntary resolution to problems affecting gas processing, pipelines, wholesale and retail functions. GIC can recommend full regulation where voluntary solutions cannot be found.

In September 2018, a faulty valve curtailed production from offshore wells in the Pohokura gas field for three months. It was Pohokura's second outage in 2018. While the first outage passed without incident, the second coincided with low hydro levels, outages in other fields, and high competing demand for gas from petrochemicals and agriculture. In combination, these factors led to a large, sustained and unprecedented rise in the wholesale electricity price, with serious consequences for exposed households and businesses.

Outages at Pohokura have raised questions about disclosure and governance in the gas industry. In a letter to GIC in July 2018, the Minister for Energy and Resources asked the GIC to report on whether disclosure requirements are adequate.¹ The Electricity Price Review's (EPR) options paper released on 18 February favoured preliminary exploration of establishing a joint electricity and gas regulator and strengthening disclosure rules.

What we were asked to do

The Major Electricity Users Group (MEUG) asked TDB Advisory Ltd (TDB) to conduct a high-level assessment of alternative institutional arrangements for governing the gas sector. We have been asked to identify and consider issues in the current governance regime, in particular disclosure requirements, of the gas sector and the advantages and disadvantages of including the option of establishing a joint gas and electricity regulator. This interim report presents our findings from stakeholder engagements and desktop research to support MEUG's submission on the EPR's options paper. Our final report is due by the end of April.

What we did

Between 27 February and 15 March, TDB interviewed 22 gas industry stakeholders including upstream and downstream firms, experts, and regulators. Interviews were mostly conducted under Chatham House rules. We reviewed legislation, past gas-sector reviews, the Electricity Authority's 28 February Undesirable Trading Situation (UTS) decision, and documents from the GIC. We take other policy settings as given.

¹ Letter to GIC by Hon Megan Woods, 25 July 2018. Available from: <https://www.gasindustry.co.nz/dmsdocument/6412>

Initial findings

Information disclosure

Our engagement suggests information disclosure is the primary concern of stakeholders. There is strong and widespread dissatisfaction about the distribution and quality of information through the Pohokura outage. Stakeholders told us limited information significantly affected their planning and execution of their responses to the Pohokura outage. Considerable effort was diverted to finding information. We were advised of one (alleged) instance of a substantial financial transaction that would not have occurred but for better disclosure. There is a wide expectation that disclosure rules should be strengthened. We did not encounter express disagreement with this view.

Factors identified as preventing better information sharing included: internal company practices; rules in contracts against information sharing; the underlying uncertainty of the problem and resolution; and the higher concentration of New Zealand gas supply compared with other countries.

Information asymmetry is not limited only to the release of information into the public domain. It also includes quality of information (accuracy, substance); timeliness; certainty of disclosure (if there is new information stakeholders are made aware²); consistency (different stakeholders have the same facts); and availability ("one source of truth" to reduce search).

A small number of respondents alleged "gaming" i.e. deliberate withholding of information for financial advantage. This claim was investigated by the EA in its UTS decision and rejected. It is widely believed some market participants traded on information available to them. Several respondents said they had investigated whether a breach of law had occurred but none reported finding any. EA and ASIC investigations are ongoing, and we have not uncovered any concerns about the integrity of those processes.

Despite concerns around disclosure, a number of stakeholders indicated that business costs from the Pohokura event arose primarily from the disruption to gas supply, rather than inadequate disclosure. It is likely that wholesale electricity prices primarily reflected gas scarcity rather than information asymmetry. Although instances of opportunistic behaviour³ are alleged to have occurred, it is not clear these instances *depended* on information asymmetry, although that is possible. Several sources suggested more information was in the public domain than some stakeholders realised. Regardless, if concerns about information asymmetry and resulting uncertainty carry the potential to reduce confidence in the gas sector or the wider energy sector then increased disclosure may have benefits.

Our preliminary view is support for the introduction of disclosure rules for planned and unplanned outages of upstream gas production. Disclosure rules for commercial information could carry greater risks of unintended consequences. It is not clear what problem commercial disclosure might solve.

² Stakeholders also noted the value of being made aware when there is not new information.

³ The opportunistic behaviour we refer to here is the allegedly creative use of contractual terms between gas suppliers and purchasers. We are not referring to changes in energy portfolios through market trading, discussed in the EA's UTS decision.

Security of supply

Given gas supply was the underlying issue, we were surprised at the limited concerns over reliability of supply. Pohokura had been reliable until 2018. Reliability declines as fields age. We saw no evidence New Zealand is unusual in reliability. Consultation revealed the mechanisms that support technical reliability including the financial cost of outages for well owners; checks conducted by insurers; downstream buyers may commission expert evaluations of equipment and procedures during contract negotiations; and the threat of legal action by a field's owners against its operator.

Co-regulation model

The Gas Act establishes the co-regulation model. The GIC is owned by fourteen companies in the gas sector from upstream and downstream, each holding one \$1 share. GIC's board has three industry directors and four independent directors. The Chair must be independent (GIC constitution 21.2). Co-regulation is based on voluntary compliance with industry-developed solutions under the threat of full regulation. Under the Gas Act model, GIC may recommend a regulated solution but must first exhaust options for voluntary solutions. The Act puts strong consultation obligations on GIC.

Views varied considerably on whether co-regulation is fit for purpose. A significant number of respondents believe the GIC is too close to industry, or captured, and is reactive rather than proactive. These concerns were connected to the prolonged transmission access negotiations prior to 2016, pipeline risk management, and curtailment rules setting by the Critical Contingency Operator (CCO). A small number of stakeholders have strong objections to the co-regulation model.

An initial review of the literature confirms industry capture as an inherent risk of self-regulation. However, the literature also identifies countervailing protections against capture including the regulator's desire to be seen as competent by government and industry. Some stakeholders noted that GIC's board is careful to signal its independence, for example by having only independent directors vote on major decisions (e.g. the Gas Transmission Access Code, or GTAC).

GIC has incentive to maintain the confidence of the Minister for Energy and Resources. The Gas Act provides that the Minister may replace the GIC with an "Energy Commission", which is the Electricity Authority in the Act (s43ZZH(2)). In effect, the GIC serves at the will of the Minister. This is a potential counterweight to capture risks.

We heard roughly divided views on whether disclosure is likely to present a sterner test for GIC and the co-regulation model than GTAC. Disclosure may differ from GTAC in an important way. GTAC set access rules to a natural monopoly asset (pipelines), and the presence of that asset introduces an element of compulsion. Provided GTAC has legitimacy then the pipeline owner is in a position to decline access to anyone who disagrees with the GTAC's terms. Disclosure, on the other hand, is purely voluntary. In its disclosure options paper, GIC notes at least one industry participant has said it will not cooperate with voluntary disclosure.

GIC performance

GIC is seen generally as competent by those we spoke with. The recently-completed GTAC process is widely, though not universally, regarded as well-executed. GIC's approach of consulting extensively and publishing all submissions is widely supported. However, a

small number of stakeholders are very critical of the GIC's performance. Despite their frustration, these stakeholders spoke highly of the GIC staff's expertise, and one spoke of a recent performance improvement.

Each of the following issues were raised by a number of stakeholders. A number were uncomfortable with the industry-led approach in GTAC, seeing it as the regulator's role to lead. GIC revealed its position on GTAC late on the process, according to some stakeholders, so "everyone was in the dark".

Some stakeholders asked whether GIC is sufficiently proactive – it is not clear, for example, whether information disclosure issues in the first Pohokura event might have justified a proactive response by GIC in advance of the Minister's July request. A small number of stakeholders also had concerns about whether GIC has been sufficiently reactive, citing GIC's alleged reluctance to look further at pipeline risks and CCO curtailment rules noted above.

Regarding compliance with existing rules, we did not hear concerns about GIC's enforcement.

Wholesale market performance during Pohokura

We asked stakeholders about the performance of wholesale market, including bilateral and spot market trades, during the second Pohokura outage. Separate to the question of information sharing is whether scarce gas ultimately found its way to its highest value use. A notable aspect of the second Pohokura outage was a loss of market liquidity throughout the event. Consultation revealed significant off-market (bilateral) trading of gas rights. Although some downstream users paid a high price for gas, we did not find evidence or hear suggestions that scarce gas supplies failed to find their highest value use during the Pohokura event. Furthermore, other than information asymmetry, we did not find any constraints on secondary trading of gas rights. Our interim view is that the wholesale gas market including bilateral trading performed well though the second Pohokura outage.

On the merits of a joint regulator

On the joint electricity-gas option, the EPR report of 18 February said it could "develop and enforce regulations for both industries in a more consistent and coherent way, which would reduce uncertainty for regulated businesses. Economies of scale are likely to result in lower total costs."

Our consultation did not reveal coordination of gas and electricity sector regulation as a concern. Gas information disclosure rules are below expectations. The primary consistency issue, uneven access to information, sits within the gas sector. There is a level of cooperation between EA and the GIC currently.

Consultation revealed only limited support for a joint electricity-gas regulator, or an energy sector-wide regulator. Many stakeholders could not see what problem is solved by a joint regulator. The weight of opinion we heard in consultation is that the sectors are quite different in most respects. One stakeholder suggested the cooperation that is occurring now between the two regulators may be exploiting some of the benefits of forming a joint regulator. A number of stakeholders were concerned that gas, the smaller of the two sectors, could be disregarded under joint regulator.

The factors cited by some stakeholders in support of a joint regulator included: the co-regulation model is vulnerable to gridlock; full regulation may bring greater independence, a more proactive approach and “more teeth”; there may be performance benefits from achieving “critical mass”.

Overall though, at this stage we have not been able to identify a strong case for a joint regulator. A benefit of self-regulation (including co-regulation) is low costs. Whatever scale economies could be realised from amalgamation should be considered alongside the additional costs of the shift from self- to full regulation. More importantly though, the administrative costs are only a small portion of the total economic costs of regulation. Other more significant considerations are likely to be the impacts of any merger on the compliance and deadweight costs of regulation in the gas and electricity sectors.

A proper analysis of the costs and benefits of merging the two regulators would need to consider:

- the problems that a merger is seeking to address. At this stage it appears to us that the principal concerns are the adequacy of disclosure in the gas sector and some concerns around the effectiveness and scope of the GIC;
- the different options for addressing the problem(s). There may be more direct and less costly means of addressing the core problems than merging the two regulators. These options include changes in the GIC’s objective, legislated scope, processes for budget and workstream setting and rules around term limits.
- the pros and cons of the different options. Alongside other factors discussed in this note, we suggest the costs and uncertainty of a change in regulation structure, and options for private responses (contract or business structure) to disclosure and security of supply issues, are also relevant to the case for joint regulation.

Next steps

From here we will seek further engagement with the GIC in particular to discuss the feedback from stakeholders and develop our analysis of the options for changes in governance, regulation and legislation.