Submission on Gas DPP Issues Paper – Form of Control

30 April 2010

Introduction

1. Vector welcomes the opportunity to provide this submission on the Commerce Commission's ("**Commission**") consultation paper *Initial Default Price-Quality Path for Gas Pipeline Businesses: Issues Paper*. As requested, this submission responds only to section 4 of the consultation paper, *Form of Control*. A response to the remaining sections will be provided by 14 May 2010.

Form of price control

2. Vector fully agrees with the Commission that incentive regulation is more consistent with the Purpose of Part 4, particularly section 52A(1)(b), than rate of return regulation. We agree that incentive regulation is appropriate for the Initial DPP for Gas Pipeline Businesses ("**GPBs**").

Choice between revenue cap and weighted average price cap

3. The Commission has proposed that a revenue-cap is appropriate for transmission price control and that a weighted average price-cap is appropriate for distribution price control. Vector notes that, whilst the intention of each approach is to increase their productive efficiency, they create very different incentives for suppliers with differing advantages and disadvantages.

Advantages and disadvantages of a weighted average price cap and a revenue cap

4. Under a revenue cap GPBs are relatively indifferent to changes in billable quantities from existing customers, as prices can be adjusted to ensure that the allowable revenues are achieved. However, a revenue cap could limit or severly diminish GPBs' incentives to grow the gas transmission market, or to connect new customers or offer additional capacity, because under a revenue cap GPBs may need to apply for a CPP to accommodate new customers that require significant new capex and/or opex investments.

5. By contrast, a weighted average price cap provides GPBs with incentives to pursue new volumes, and it more readily accommodates new customers (and their associated capex requirements). Under a weighted average price cap it need not be necessary to apply for a CPP to accommodate a new customer if the new customer will provide sufficient revenues to cover the additional costs of the investment.

6. For major investments, GPBs may well need to apply for a CPP but this would be true under both a revenue cap and a weighted average price cap.

7. The question of which form of control would best suit a GPB over a regulatory period is a complex decision that will involve the weighing of a variety of factors. In our view, that type of decision is best made by individual suppliers of gas pipeline services for each regulatory period once a good understanding has been reached of how the Commission would implement the different caps.

Option to choose between a weighted average price cap and a revenue cap

8. In Vector's submission on the most recent process consultation paper on the Electricity Distribution Business Default Price-Quality Path[1] we recommended that suppliers of electricity lines services should have the ability to choose whether to be subject to a weighted average price cap or a revenue cap, depending on which best met their immediate business needs. For example, a looming issue for the industry is to adjust tariff structures based on the increased ability, arising from the roll out of smart meters, to signal costs and benefits to consumers. A revenue cap would facilitate those adjustments because it would remove risk from both suppliers and consumers that actual reactions to price signals turn out to be more or less than expected from a total revenue perspective. We recommend here that the option of choosing whether to be subject to a weighted average price cap or a revenue cap should also be made available to suppliers of gas pipeline services.

9. The decision on the form of price control applied to GPBs should be made with the Part 4 Purpose Statement in mind. In principle, both a revenue-cap and a weighted average price-cap can limit GPBs' ability to extract excessive profits, share benefits with consumers and provide incentives for GPBs to improve efficiency. Whether a revenue cap or a weighted average price cap will best deliver incentives for GPBs to innovate and invest will depend on the market circumstances confronting each supplier. It is not necessarily the case that the same approach will be optimal for all suppliers or consumers. Therefore the Commission, in order to provide maximum incentives to invest, should be prepared to allow flexibility among GPBs regarding whether they are subject to a revenue cap or a weighted average price cap.

It should be possible to have different forms of control for different GTBs

10. Vector disagrees with the Commission that the form of control for transmission must necessarily be the same for both Vector and Maui Development Ltd. ("**MDL**"). Vector and MDL have provided preliminary indications (in the

[1] *Submission on Further Work for the Reset Default Price-quality Path for Electricity Distribution Businesses: Process Paper*, 19 March 2010, pp. 2-3.

absence of full visibility on the implementational details on the form of control) that the commercial context for their businesses are quite different, which then has implications for the form of control. For the Commission to impose a single solution on both businesses would therefore be ultimately to the detriment of consumers. We are not aware of any legislative requirement or efficiency reason that would require the Commission to make such a decision.

More detail is required of how a weighted average price cap and a revenue cap would be implemented

11. Vector can comment on the choice between the two options at a principled level. However, in the final analysis, the decision about whether a weighted average price cap or a revenue cap is preferred will depend in part on the way in which the caps will be implemented. We would need significantly more detail than has been provided so far on how a weighted average price cap and a revenue cap would be implemented before it would be possible to provide a comprehensive assessment of the risks and benefits of each and then opt for one approach over another.

Vector's preliminary view

12. Despite the above comments, Vector thought it would be helpful to the Commission to provide our initial views on the choice between a weighted average price cap and a revenue cap. These views are subject to change once further information is provided regarding the implementation details. Our initial view is that a weighted average price-cap is likely to be appropriate for both Gas Distribution Businesses ("**GDBs**") and Vector's Gas Transmission Businesses ("**GTBs**"). We do not support a revenue cap at this stage.

13. Vector agrees that gas distribution and gas transmission are sufficiently different to require separate default price-quality paths. However, we do not believe the differences are so large they necessarily require a different form of control.

14. The proposal for different forms of price control for distribution and transmission appears to be based on assumed differences in demand, cost structures and capital expenditure profiles. It is not clear what evidence the Commission has used to develop this assumption. Vector's preliminary view is that the relationship between the fixed and variable cost structures is not materially different between our transmission and distribution businesses. In particular, both businesses have material system fixed asset costs, but both businesses incur further capital to connect new customers and maintain or expand capacity, hence

there is a need to have a form of control that allows Vector's revenues to adjust in proportion to variation in fixed costs. In our view, a weighted average price cap, best allows adjustments in revenues to accommodate new customers' requirements as and when they occur. Potentially MDL's system is quite different from Vector's, in that it is not as frequently making capital investments that would otherwise need to be accommodated under a revenue cap; and because of the more variable nature of their tariff structure, volume risks that are outside of MDL's control are a more acute concern.

15. Vector does not agree that the lumpy and infrequent nature of transmission investment means that a revenue cap is necessarily appropriate for Vector's gas transmission system. In fact, Vector is subject to sufficiently frequent connection requests necessitating new investments that a revenue cap would be costly to operate under. Under either form of control a major new 'lumpy' investment that requires revenue increases beyond those immediately arising from a new customer would be likely to necessitate an application for a Customised Price-Quality Path ("**CPP**"). For example, where a pipeline capacity expansion occurs it is necessary to raise all consumers' charges, not simply the last customer that triggers the investment.

Implementation issues

Current approaches work well

16. In general, Vector is comfortable with the broad approaches employed in the implementation of weighted average price cap regulation for the controlled gas network and electricity networks. Subject to minor adjustments, we do not see a need for substantial changes to the current, well established approach.

Use of lagged data is preferred for quantities, inflation and pass through costs

17. As a point of principle, Vector prefers methodologies that reduce the risk of technical breaches, particularly regarding forecast risk. Our preference is therefore for a methodology similar to the weighted average price cap under the GFA as this uses lagged data. Specifically, for the Gas DPP, Vector supports the use of lagged historical reference quantities that are annually updated.

18. The price path assessment formulae should take account of inflation by using CPI, providing GPBs are not subject to risks associated with differences between forecast and actual CPI changes. The timing in terms of quarters used is also important. GPBs will need sufficient time for CPI data from the most recent quarter to be available to make price adjustments and allow for appropriate

internal governance processes. The timeframes provided under the Commerce Act (Vector Natural Gas Services) Authorisation 2008 ("**the Authorisation**") whereby CPI data from the most recent quarter is published less than two weeks before prices must be set are insufficient and create costs and last minute process difficulties.

19. Vector recommends that pass-through costs are set using actual quantities, not forecast quantities. As noted above, forecasting incurs costs and creates risks for GPBs of technical breaches. A low-risk methodology is preferable. The approach to pass through costs employed in the Authorisation appears to offer a pragmatic and workable solution.

20. The Commission has asked if there is a need to reconcile forecast and actual volumes for pricing and compliance purposes. In Vector's view, this is unnecessary for a weighted average price cap that uses lagged quantities. However, it may be necessary for a revenue cap, particularly at the end of a regulatory period when setting the cap for the next period.

21. The Commission has asked how compliance with the weighted average price cap should be assessed. In our view, there would need to be some flexibility for a revenue cap and for a weighted average price cap, particularly one that is reliant on forecasting to set prices but ex-post assessment of compliance. Depending on the exact mechanism, there may be a need for some form of unders and overs mechanism to apply to areas where there is any uncertainty or risk of technical breaches due to forecasting errors.

Volume adjustment mechanism

22. An ex-post volume adjustment mechanism is essential if a revenue cap is used. Such a mechanism should be unnecessary for a weighted average price cap that uses lagged quantities, but would be needed if the weighted average price cap relied on forecast quantities.

23. The Commission has asked for views of how a GTB's variable cost recovery should be treated under a volume adjustment mechanism. Vector's view is that a mechanism would be necessary to reimburse consumers in the event of over-recovery or for suppliers to recover lost revenue from consumers in the event of under-recovery. Transpower's Economic Value Adjustment mechanism may be an appropriate model to use. Adjustments could be made each year based on under- and over-recovery in the previous year with an aim to have no outstanding under- or over-recovered amount at the end of a regulatory period. Alternatively, a net adjustment could be made at each five year reset through the Po adjustment to

return any over-charging to consumers or recover any under-charging from consumers, adjusted for inflation. In either case, it may be necessary to smooth the price adjustment over a number of years to avoid price shocks.

24. The Commission has also sought views on how a volume adjustment mechanism and suppliers' pricing structures should interact. In our view, the way in which economic value is distributed to or recovered from consumers should reflect the classes of consumers from which the value was originally derived.

Cost structure

25. Vector considers that the process of accounting for a GTB's past and future cost structure under a DPP is a matter for pricing methodologies used by the GTB. As noted below, Vector supports the Commission's view that a pricing methodology input methodology should not be set for GPBs as part of the DPP process.

Building blocks and capital contributions under a revenue cap

26. Vector would also welcome clarity regarding how the Commission would develop a revenue cap. A robust revenue cap necessarily implies a building blocks approach which would not be in line with a low-cost DPP arrangement. In the absence of a building blocks model underpinning the setting of a DPP, it is unclear how the Commission would set a revenue cap that could anticipate changes in costs over the regulatory period, particularly where a GPB is connecting new customers. A revenue cap would prevent any recovery of connection-related capex unless it was explicitly allowed for in setting the cap (which is unlikely to be possible as the DPP regime is not a detailed building blocks approach). Vector would welcome clarity from the Commission on how capital contributions would be treated under a revenue cap.

27. It would seem inconsistent with the section 53K requirement (that DPP/CPP regulation should be low cost) if GPBs were forced to apply for a CPP just to connect new customers because the connection-related capex did not form part of the setting of the revenue cap. This might also require more than on CPP in a five year period, which is not permitted under the Act. Therefore capital contributions would need to be outside any revenue cap.

Pricing methodologies under the DPP

28. Vector supports the Commission's view that "suppliers will not be required to apply a pricing methodology input methodology under a DPP, as the Commission

considers that the net benefits of doing so may not be sufficient"[2]. We consider, however, that it is reasonable for GPBs to disclose information on how prices have been derived and continue to support a principle-based approach to these matters. We do note that there are heavy compliance costs associated with the disclosures made under the Authorisation for the controlled businesses, especially the audit requirements, whereby external auditors are required to opine on necessarily subjective economic judgments made by the business in determining their tariffs and tariff structures. This is not a task that auditors are well-suited to.

Contact details

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[2] Commerce Commission, *Initial Default Price-Quality Path for Gas Pipeline Businesses: Issues Paper*, 12 April 2010, paragraph 4.4.