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20 January 2012

Matthew Lewer
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Commerce Commission
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Dear Matthew,

Cross-submission on the Initial DPP for GPBs Draft Reasons Paper

Introduction

1. Vector welcomes the opportunity to make a cross-submission on the Commerce Commission's (Commission) Draft Reasons Paper "Initial Default Price-Quality Paths for Gas Pipeline Businesses", 21 November 2011. No part of Vector's submission is confidential and we are happy for it to be publicly released.

Authorised and non-authorised GDBs

2. This submission re-confirms Vector's support for the Commission's intention to allow Vector to treat its authorised and non-authorised GDBs separately for the first Assessment Period for the purposes of calculating notional revenue, but to remove this discretion from the second Assessment Period.

Service quality

3. Vector endorses the comment made by Powerco that emergencies are taken "very seriously" and Gas Pipeline Businesses (GPBs) can be expected to "endeavour to reach the emergency as quickly as possible", regardless of whether one or each of the Emergency Response Times (ERTs) have been breached.[1] In a similar vein, GasNet expressed concern "at the inference ... that gas suppliers may have a reduced incentive to respond to an emergency in a timely manner without including an upper limit to the quality standard ... It is inconceivable that a GDB would intentionally delay responding to an emergency event ..."[2]

4. Vector also agrees with Powerco's comment that "a limit of 100%" may lead to breaches of the DPP as a result of circumstances of which GPBs have no control

[1] Paragraph 9, Powerco, "Initial Default Price-Quality Paths for Gas Pipeline Businesses: Draft Determination and Reasons Paper", 19 December 2011.
[2] Paragraph 31, GasNet, "Submission on Initial Default Price-Quality Paths for Gas Pipeline Businesses, Draft Reasons Paper", 19 December 2011.

"For example, it is reasonable to expect a situation in the North Island in the next five to ten years that washes out a bridge or road meaning engineers are not able to reach an incidence within three hours",[3] and that "[i]n the absence of defined exemption criteria, a 100% target is unreasonable and could lead to gas personnel taking unnecessary safety risks to meet the target."[4]

5. Vector considers that these comments reinforce the merit of our recommendation for the Commission to include a "force majeure" type clause to deal with situations where a GPB, due to circumstances outside of its control, could not have been reasonably expected to meet the 180 minute ERT service quality threshold.

Definition of an emergency

6. Powerco, MDL and GasNet all made the comment that emergencies can arise where a GPB engineer or representative is not required to attend, or is not required to immediately attend. They provided several examples of this situation, including where emergency services call the GPB to inform them of an emergency, but that there was no gas leak or the gas leak was from a non-network source.[5] Vector considers that it would be sensible to amend the definition of emergency to reflect these circumstances.

CPP applications

7. Vector and other regulated suppliers have submitted to the Commission that:

   a. There is significant cost and risk involved in submitting a CPP proposal; a particular risk being that the CPP could be worse than the DPP;

   b. Regulated suppliers will not necessarily make a CPP proposal even if they do not expect to be able to recover a commercially-sustainable rate of return under the DPP;

   c. Regulated suppliers may be better off reducing OPEX or CAPEX as a way of mitigating against expected losses under the DPP, rather than submitting a CPP proposal; and

   d. Regulated suppliers will only submit a CPP proposal if they expect to be better off than under the DPP.

8. These concerns are reinforced by the comments made by GasNet in their submission:[6]

> … we interpret the Commission's desire to initiate the opportunity for CPPs as an expectation that a supplier may choose to apply for a CPP in order to either seek remedies for the reduced

[3] Paragraph 10, Powerco, "Initial Default Price-Quality Paths for Gas Pipeline Businesses: Draft Determination and Reasons Paper", 19 December 2011.
[4] Paragraph 11, Powerco, "Initial Default Price-Quality Paths for Gas Pipeline Businesses: Draft Determination and Reasons Paper", 19 December 2011.
[5] Paragraph 13, Powerco, "Initial Default Price-Quality Paths for Gas Pipeline Businesses: Draft Determination and Reasons Paper", 19 December 2011.
[6] Paragraphs 22 - 23, GasNet, "Submission on Initial Default Price-Quality Paths for Gas Pipeline Businesses, Draft Reasons Paper", 19 December 2011.

starting prices, or to obtain prices which better meet their investment needs. However, we submit that this option is severely compromised by the following circumstances:

- A supplier is restricted from applying for a CPP within 12 months of a DPP reset (section 53Q(3)) which suggests any CPP application window prior to the reset will be limited to the 3 months commencing 1 July 2012. As the Determination will not be made until the end of February, there is insufficient time for the CPP proposal to be prepared, independently verified, audited and submitted;

- The earliest any pricing remedy is available under a CPP will be for the pricing period commencing 1 October 2013 (given the CPP assessment and approval process), which is exactly the same time as the proposed DPP reset;

- A supplier will not know the DPP that will apply to it from 1 October 2013, and thus will not know the counterfactual. This will prevent it from assessing whether or not a CPP is required. As the 1 October 2013 reset may include claw back for the period commencing 1 July 2012, it is also not possible to quantify the counterfactual from the beginning of the Initial DPP;

- As supplier is only able to make one CPP application within a regulatory period, it is unlikely any applications will be made before the reset, given the uncertainty that exists; and

- A supplier is unable to recover its costs incurred in making a CPP application, other than audit, verification, application, and the Commission's fees which are associated with a successful proposal.

Accordingly we do not believe that the CPP is a real option for GDBs before the proposed reset in October 2013. Even if a reset is not implemented, it is the uncertainty regarding the potential for a reset which prevents GDBs from investing in a CPP proposal prior to that date. In addition, a CPP is not useful for seeking remedy for the proposed price reduction at 1 July 2012, as it can achieve no more than the proposed claw back option discussed above.

9. These statements are also consistent with the comments made in 2008 by Mark Berry and Lewis Evans that:[7]

> There will be few applications for customised proposals. The risks in submitting such proposals will be high, because once the election is made to go down this path, there is no ability to withdraw the application. Applicants can end up worse off under the customised proposal path if there is a finding that the default price-quality is too high, for whatever reason, as the Commission can order claw back in relation to some or all of the over-recovery. The time within which these applications will be processed (10-15 months) may act as a further deterrent.

[7] Page 7, Mark Berry and Lewis Evans, The New Regulatory Regime for Electricity Lines Businesses: Great Expectations Unfulfilled, 26 September 2008, available at http://www.iscr.org.nz/f466,13532/13532_New_Regulatory_Regime_Electricity_Lines.pdf.

Balancing gas recoverable clarification

10. MDL has made proposals for ensuring the legitimate costs incurred in gas transmission balancing are able to be recovered.[8] Vector refers the Commission to its previous comments on this matter.[9]
11. Gas balancing plays an important function for gas shippers and consumers; it ensures gas inventory within the transmission system is kept within safety limits and ensures the availability of gas to consumers at appropriate pressure. Too much gas in the transmission system could result in safety issues due to increased pressure. Too little gas could jeopardise security of supply because pressures are too low to enable gas flow.

12. Without effective balancing, the reliable transportation of gas is impossible.

13. Welded parties under the Maui Pipeline Operating Code (MPOC) are required to offtake an amount equal to the "Scheduled Quantity", and shippers under the Vector Transmission Code (VTC) are obliged to balance their receipts and deliveries on any day.

14. While shippers are required under the VTC to use reasonable endeavours to maintain balanced positions for the gas they receive and deliver on a daily basis, this does not always occur. Where limits at Welded Points are exceeded and MDL has to purchase 'balancing gas' to balance the Maui Pipeline, Vector, as the Welded Party, is responsible under the MPOC to MDL for the cost of that balancing gas. While Vector passes these costs on to shippers under the VTC, a problem arises because the costs cannot always be attributed to a specific causer because Vector cannot always identify which shipper over or undertook.

15. The Gas Industry Company (GIC)has concluded that "Without effective balancing, reliable transportation of gas is impossible. Effective balancing of transmission pipelines is therefore a key element of successful open access."[10] The GIC observes that the costs of balancing are not borne by the causers – meaning that parties who caused the balancing gas transaction are not being held (fully) responsible for the cost of that gas.
16. In 2009, the GIC proposed a 'participative regulation' approach to balancing.[11] This approach would have comprised a set of rules for balancing arrangements that provide for pipeline operators to jointly develop a balancing plan and appoint a single balancing agent. The GIC's attempts to introduce regulation have been unsuccessful as various commercial and vested interests inevitably come into play.

17. The GIC is considering changes to the MPOC, proposed by MDL, in relation to balancing arrangements. We recommend that the Commission coordinate closely

[8] Paragraphs 7 to 15, MDL, untitled submission to the Commerce Commission, 19 December 2011.
[9] Paragraphs 74 to 77, Vector, Submission to Commerce Commission on Information Disclosure Discussion Paper, 11 September 2009.
[10] GIC "Transmission Balancing Second Options Paper", July 2009.
[11] GIC "Transmission Balancing Second Options Paper", July 2009.

with the GIC to promote efficient gas balancing arrangements and to ensure balancing costs are able to be recovered by GPBs.

Mitigating compliance costs and other refinements

18. Vector is supportive of

    a. Powerco's recommendation that the deadline for audits of service quality be changed to 30 January each year.[12]

    b. Powerco's recommendations that the lagged pass through and recoverable cost provisions be amended, for the avoidance of doubt, to "make it completely clear that all pass through costs and recoverable costs are lagged."[13]

    c. GasNet's recommendation that the definition of gas distribution network should include termination as up to the inlet of the Gas Measurement System (GMS), and not just the outlet of the GMS.[14]

    d. MDL's recommendations on gas balancing.[15]

Revenue cap versus price cap

19. MGUG continue to litigate the matter of whether Vector's Gas Transmission Business (GTB) should be subject to a Total Revenue Cap (TRC) or a Weighted Average Price Cap (WAPC).

20. Vector does not believe MGUG's arguments have merit.

Misrepresentation of Vector statements

21. Vector believes MGUG's arguments again contain factual errors.

22. MGUG assert, for example, that "There is more conjecture than evidence in Vector's statement as to why a stable past revenue pattern <u>should suddenly become unstable in the next four years</u>" (emphasis added).[16] The concerns about revenue risk Vector has are over the medium to long-term. It is not sufficient to rely on statements such as that "significant industrial users are <u>currently</u> committed to their gas investment" (emphasis added).[17] Changes in economic circumstances can have substantive impacts on the operation of large industrial

[12] Paragraph 17, Powerco, "Initial Default Price-Quality Paths for Gas Pipeline Businesses: Draft Determination and Reasons Paper", 19 December 2011.
[13] Paragraphs 18 – 19, Powerco, "Initial Default Price-Quality Paths for Gas Pipeline Businesses: Draft Determination and Reasons Paper", 19 December 2011.
[14] Paragraph 32, GasNet, "Submission on Initial Default Price-Quality Paths for Gas Pipeline Businesses, Draft Reasons Paper", 19 December 2011.
[15] Paragraphs 7 - 15, MDL, untitled submission on the Initial Default Price-Quality Paths for Gas Pipeline Businesses: Draft Determination and Reasons Paper, 19 December 2011.
[16] Paragraph 5c, MGUG, "Re: Initial Default Price-Quality Paths for Gas Pipeline Businesses – Draft Reasons Paper 21 November 2011", 19 December 2011.
[17] Paragraph 5ci, MGUG, "Re: Initial Default Price-Quality Paths for Gas Pipeline Businesses – Draft Reasons Paper 21 November 2011", 19 December 2011.

users. This is presumably why MGUG qualified their statement about large user demand with "currently".

23. MGUG's arguments in support of WAPC rely heavily on its proposition that "Vector's own comments ... suggest" that, under a TRC, GTBs will not have incentives to innovate and invest.[18] MGUG rely on a clear misrepresentation of Vector's comments to draw this conclusion. Specifically, MGUG has misrepresented Vector's statement "that Vector does not have any commercial incentives to overbook capacity as the Vector Transmission service is regulated by the Commerce Commission. Revenue will be subject to a cap" (emphasis added). Vector's statement was deliberately silent on the type of cap, as the statement stands regardless of whether a WAPC or TRC is adopted.

24. Further, MGUG has incorrectly translated a lack of incentives to "overbook capacity" to mean a lack of incentives to "innovate around Vector's existing investment".[19] These are very different statements. If there were no cap, be it a WAPC or TRC, Vector would have incentives to overbook capacity and use congestion to maximise returns. This would be inefficient. Instead Vector faces a cap that means we do not have incentives to partake in inefficient practices, as we cannot keep the rents.

Short versus long-term

25. One of the problems with MGUG's arguments around TRC versus WAPC is that MGUG has adopted a short-term (current regulatory period) focus.

26. This is seen, for example, in MGUG's comment that "TRC will fail to meet the needs of the market, at least in the short term" (emphasis added).[20] The focus of the Commission, in accordance with its statutory objective, should be to maximise the long-term benefits to consumers, not on the short-term.

27. Likewise, MGUG argues that "[g]iven lead times it is doubtful that there will be any meaningful investment made in the next four years. The argument that a TRC incentivises investment is therefore more academic than real"[21] and argues that "stable past revenue" would be unlikely to "suddenly become unstable in the next four years".[22]

28. Vector's arguments in support of the Commission's decision to adopt TRC are not just based on what may happen within the current regulatory period, or investment impacts over this short period of time, but rather over the risks and

[18] Paragraph 5i, MGUG, "Re: Initial Default Price-Quality Paths for Gas Pipeline Businesses – Draft Reasons Paper 21 November 2011", 19 December 2011.
[19] Paragraphs 5d-e, MGUG, "Re: Initial Default Price-Quality Paths for Gas Pipeline Businesses – Draft Reasons Paper 21 November 2011", 19 December 2011.
[20] Paragraph 5e, MGUG, "Re: Initial Default Price-Quality Paths for Gas Pipeline Businesses – Draft Reasons Paper 21 November 2011", 19 December 2011.
[21] Paragraph 5g, MGUG, "Re: Initial Default Price-Quality Paths for Gas Pipeline Businesses – Draft Reasons Paper 21 November 2011", 19 December 2011.
[22] Paragraph 5ci, MGUG, "Re: Initial Default Price-Quality Paths for Gas Pipeline Businesses – Draft Reasons Paper 21 November 2011", 19 December 2011.

uncertainty that may prevail over the longer-term, and the life of Vector's gas transmission assets.

29. MGUG seems to be implying it does not matter if a TRC doesn't incentivise investment if investment would not occur anyway, in the short-term. Incentives to invest are not like a light switch that can simply be switched on and off as the need arises. The regulatory regime needs to provide for consistent and enduring incentives for regulated suppliers to have confidence to invest in long life infrastructure.

30. It is Vector's expectation that the form of cap the Commission would adopt for the first regulatory period would endure beyond that regulatory period, and therefore the decision on the form of cap needs to be based on long-term dynamics and not short-term expediency that may be perceived to advantage certain groups.

Capacity constraints and risk

31. MGUG assert that "[r]evenue uncertainty for a monopoly should not be a driving consideration for a competition regulator" and "Vector's risk tolerance in an uncompetitive market should not limit what is best for consumers."[23]

32. Risk is a cost of operation just like opex and capex. The Commission needs to ensure regulated suppliers expect to be able to recover these costs. If the Commission imposes arrangements on a regulated supplier that increases their costs or risks these need to be reflected in allowable revenues.

33. Consumers should expect regulated suppliers to endeavour to operate in an efficient manner that minimises cost and risk.

34. MGUG tries to suggest there is a trade-off between "revenue uncertainty" for Vector's GTB and "the risks faced by the market (such as restricting demand in order to protect transmission revenue risk)".[24] Such a trade-off is illusory. Vector has not and does not restrict demand in order to protect transmission revenue. Restrictions on demand growth reflect the real and physical constraints on the North Pipeline, coupled with honouring existing contractual rights of transmission customers, including MGUG's members.

35. The reality is that the benefits to consumers of a TRC versus WAPC differ substantially between gas transmission and distribution. Application of a WAPC for gas transmission would result in materially higher risk (and costs) than it would for gas distribution. This is a matter we have traversed in previous submissions. In summary:[25]

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[23] Paragraph 5cii, MGUG, "Re: Initial Default Price-Quality Paths for Gas Pipeline Businesses – Draft Reasons Paper 21 November 20 11", 19 December 2011.
[24] Paragraph 5cii, MGUG, "Re: Initial Default Price-Quality Paths for Gas Pipeline Businesses – Draft Reasons Paper 21 November 2011", 19 December 2011.
[25] Vector, "Submission on the Commerce Commission's Initial Default Price-Quality Path for Gas Pipeline Businesses: Discussion Paper", 27 May 2011.

a. Unlike electricity or gas distribution, gas transmission networks are reliant on a small number of very large customers and GTBs have no control over their entry to or exit from the market.

b. Even without entry or exit, demand could be substantially impacted by decisions of any one large user to scale down demand, for example, a large electricity generator retiring plant.

c. Significant factors driving supply and demand on Vector's gas transmission network are beyond Vector's control, making it subject to a high degree of uncertainty. Of course, all businesses face risk and uncertainty. The point is that if Vector faces an additional risk it has no control over it will need to be compensated for this risk through a higher WACC and, ultimately, higher prices for consumers.

d. These factors make it more difficult for Vector as a GTB to have confidence that its revenue requirements will be met. A revenue cap will better mitigate this risk than a price cap, thus incentivising investment.

36. Further, the physical realities of gas distribution (where there is considerable scope for growth in uptake) and the constraints on gas transmission mean the benefits of rewarding volume growth[26] are substantially greater for gas distribution than they are for gas transmission.

Investment in a second North Pipeline

37. Adoption of TRC does not, as MGUG suggest, provide "less incentive to invest in new infrastructure". Investment in a second North Pipeline would necessitate substantial price increases for gas consumers, including MGUG's members. The amount of these increases would be a function of the cost of the new pipeline and supply and demand, not whether WAPC or TRC is adopted.

38. Moreover, the price increases would be of such a scale that Vector would need to make a Customised Price Path (CPP) proposal to the Commission,[27] and the Commission would need to approve this, before the investment could occur. At this point we do not anticipate that consumers would support investment in a second North Pipeline. Congestion only happens for short periods of time in some years eg one week in 2011 when temperatures were exceptionally low. The second pipeline would accordingly necessitate substantial investment (and price increases for consumers) for a presently limited and uncertain demand.

Better utilisation of existing capacity

39. Finally, MGUG suggest there are a number of innovations such as bulletin boards, more convenient capacity trading, and greater transparency around system flows

[26] Paragraph 5cii, MGUG, "Re: Initial Default Price-Quality Paths for Gas Pipeline Businesses – Draft Reasons Paper 21 November 2011", 19 December 2011.

[27] Unless some other mechanism was adopted. For example, Vector has previously proposed a Regulatory Investment Test mechanism as part of the Default Price Path.

that could benefit the current market. Vector agrees with MGUG on this point. From Vector's perspective the merit of introduction of such initiatives does not hinge on whether the Commission adopts a TRC or WAPC.

40. MGUG would be aware that Vector has limited ability to make unilateral changes to the Vector Transmission Code (VTC). While any of the parties to the VTC can propose changes to it multilateral acceptance is required for changes in governance to take effect.

41. Vector has taken the initiative to engage and consult with industry on how we determine pipeline capacity, and to redetermine how much capacity can be made available in constrained parts of the transmission network. In this way we make informed decisions, provide transparency of our decision making and provide valuable information to markets and investors to reduce the uncertainty in their own long-term decision making.

42. Vector considers its pipeline capacity consultation to be a useful input into Gas Industry Company work streams to increase the efficiency of capacity allocation at peak times.

43. Contrary to the suggestions of MGUG about Vector's incentives, we are engaging with stakeholders in a constructive and proactive manner on these matters, allocating considerable resources in the process.

Concluding remarks

44. Vector is of the view that:

    a. The service quality measures should allow for force majeure circumstances where it is not reasonable to expect GPBs to operate within the 180 minute ERT service quality threshold;

    b. The definition of emergencies should be amended to allow for circumstances where a GPB is not required to attend;

    c. GTBs should be assured of being able to recover the legitimate costs incurred in gas transmission balancing;

    d. Compliance costs can be mitigated by changing the deadline for audits of service quality to 30 January each year;

    e. The lagged pass through and recoverable cost provisions could readily be amended to make it clear that they are all lagged;

    f. The Commission should liaise with the GIC to ensure balancing costs are able to be recovered by GPBs; and

    g. The Commission should retain a Total Revenue Cap for Gas Transmission Businesses, including Vector.

45. Care should be taken with MGUG's arguments in favour of a WAPC, instead of a TRC, for Vector's GTB:

    a. MGUG has misconstrued statements Vector has made about how the application of price control impacts on our incentives to incorrectly suggest this reflects a problem with use of a TRC.

    b. It would be unfair to characterise Vector's attempts to ensure it is not subject to unnecessary or undesirable risk as "monopolistic". Keeping Vector's gas transmission cost and risk down ultimately lowers the costs that must be recovered from customers.

    c. Whether initiatives are adopted to enhance the efficiency of utilisation of current capacity and/or ultimately whether a second North Pipeline will or should be built does not hinge on whether Vector's GTB is subject to a TRC or WAPC.

46. If the Commission has any queries regarding Vector's submission or would like further information please contact Robert Allen, Senior Regulatory Advisor, on 09 978 8288 or robert.allen@vector.co.nz.

Kind regards

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