



Vector Limited
101 Carlton Gore Road
PO Box 99882, Newmarke
Auckland, New Zealand
www.vector.co.nz

Corporate Telephone
+64-9-978 7788

Corporate Facsimile
+64-9-978 7799

23 August 2013

John Bright
Gas Industry Company Limited
Level 8, The Todd Building
95 Customhouse Quay
PO Box 10 646
Wellington 6143

Dear John

31 MAY 2013 VECTOR TRANSMISSION CODE CHANGE REQUEST

EXECUTIVE SUMMARY

- 1 This letter responds to the Gas Industry Company Limited's (*GIC*) call for submissions on its Draft Recommendation on 31 May 2013 VTC Change Request (Single Issue) (*Draft Recommendation*).
- 2 We agree with the GIC's ultimate decision, finding that Vector Gas Limited (*Vector*) validly withheld consent to the Change Request under the VTC. In its Draft Recommendation, the GIC acknowledged the pertinent difficulties with the mechanics and implementation of Contact Energy Limited's (*Contact*) Change Request.
- 3 Importantly, however, we believe that the GIC has erred in treating each of Vector's reasons in isolation. Vector withheld its consent on the basis of the five reasons taken as a whole. As discussed in this submission, these reasons taken together reinforce the GIC's decision that Vector's decision was not unreasonable.
- 4 We also agree that it is not the GIC's role to decide disputes of contractual interpretation. Further, we maintain that the clause in question could not have been intended to provide a right of appeal on the merits in relation to the Change Request at hand.
- 5 We also note that there are wider industry reviews on the horizon, which should provide an opportunity to review the broader contract change process in a considered and comprehensive way.

APPEAL AGAINST VECTOR'S DECISION TO WITHHOLD CONSENT

Legal test on appeal ***Changes to the VTC***

- 6 It is an important feature of the VTC that any change to the contract requires the consent of:

6.1 Vector; and

6.2 75% of shippers who respond to the change request.

- 7 Where Vector has not consented to a change in the VTC, a shipper may appeal to the GIC to test Vector's decision. It may do so under section 25.5(b) of the VTC.

The test to be applied on appeal

- 8 When deciding the appeal, the test the GIC applies is whether Vector's decision was objectively unreasonable. That is, a decision that no reasonable infrastructure provider would have made.

- 9 The question on appeal is not whether the GIC considers that Vector's decision was the best option. The GIC must be careful not to simply substitute its judgment. It is for the appellant to convince the GIC that Vector's decision was unreasonable.

- 10 This type of appeal differs from a general merits appeal where the substance of the proposed change to the VTC is measured against the Gas Act objectives and the Government Policy Statement (GPS).

The role of the Gas Act objectives and the GPS

- 11 There seems to be some confusion over the role of the Gas Act objectives and the GPS in testing whether Vector's decision was unreasonable. To be clear, Vector's position is that:

11.1 a decision to withhold consent which is genuinely based on the Gas Act objectives and the GPS must be considered reasonable; and

11.2 there are other grounds on which Vector may reasonably withhold consent.

The grounds for a refusal of consent are not artificially limited

- 12 Section 25.5(b) gives examples of when it would not be unreasonable for Vector to withhold its consent to a change request. These include unwanted or economically unviable capital expenditure, operating costs that cannot be recovered, adverse effects on Vector's transmission business, and the compatibility of Vector's open access regime with the open access regime on the Maui Pipeline.

- 13 Section 25.5(b) is very clear that these examples do not limit the general contractual standard that Vector's consent shall not be unreasonably withheld or delayed. We therefore agree with the GIC's view that Vector is not limited to the list of the grounds in section 25.5(b) in order to validly withhold its consent.

- 14 However, we disagree with the proposition in the Draft Recommendation that the VTC envisages a different standard be applied by the GIC on appeal depending on whether Vector's decision is driven by concerns about an inequitable impact on Vector or its business, versus issues of efficiency or effectiveness. The following suggest that this is an incorrect reading of the contract:

14.1 There is no mention in the contract of a two tier appeal structure applying to appeals against Vector's decision not to consent to a change to the contract. If this had in fact intended by the contracting parties, we could have expected it to be included in the drafting. It was not, and the GIC does not have the ability to supplement the contract;

14.2 In fact, the contract explicitly provides that the giving of examples is done "without limiting the previous part of this section 25.5(b)" – which simply

provides the general contractual standard that Vector's consent shall not be unreasonably withheld. Yet the GIC's proposed two tiered appeal structure would place a gloss on the contractual standard set by the parties;

- 14.3 The distinction the GIC draws is too hard to draw in practice. Issues of efficiency and effectiveness will often have a differential impact on Vector's transmission business, as Vector is the infrastructure provider, the only participant that is a party to every transaction under the VTC, and most exposed to reductions in efficiency and effectiveness;¹
 - 14.4 Further, the GIC's view seems counterintuitive – the GIC appears to suggest that withholding consent would be more reasonable if Vector bases its decision on pure self-interest rather than overall efficiency;
 - 14.5 The suggestion that only a material decrease in efficiency would be sufficient to warrant withholding consent to a change request² suggests the GIC could overturn a decision by Vector that was motivated by the Gas Act objectives and GPS (for example, avoiding a reduction in overall efficiency that the GIC viewed as real but nevertheless insufficiently material). This clearly ventures beyond checking for unreasonableness and into second-guessing the merits of Vector's decision.
- 15 More generally, there is no need for the GIC to impose a two tier structure on this appeal mechanism. The balance struck by the parties to the VTC in relation to proposed changes to the contract was to give Vector a consent role, and give shippers an opportunity to have an independent third party test whether any consent had been withheld unreasonably. There is nothing to suggest that the balance intended by the contracting parties is unworkable.
 - 16 We are conscious that the GIC has applied its higher standard to this appeal and still found that Vector's decision was not unreasonable. Nevertheless as a matter of principle we reiterate that there is no basis in the contract, nor need, to graft a two tier appeal structure onto this part of the VTC.

Weighing Vector's reasons for withholding consent

- 17 In our correspondence with Contact, and the GIC, we identified the considerations that we had in mind when we withheld our consent to Contact's Change Request. Each of these considerations was carefully thought through by Vector, and then we assessed the overall impact of the proposed change to the VTC.
- 18 One of the most unexpected features of the Draft Recommendation is the degree to which it treats the considerations weighed by Vector as separate grounds. Each ground is assessed individually, and while the GIC refers to the possibility of assessing combinations of Vector's reasons, and has noted where in its view some of the considerations are complementary, the Draft Recommendation is very much focused on assessing each ground separately. There is no step in the analysis when the GIC assesses the overall impact of the considerations weighed by Vector.
- 19 We submit this is an overly atomistic approach to testing whether Vector's decision is unreasonable. In arriving at our decision we tested the considerations then

¹ A point made in another context in the Draft Recommendation on page 16.

² Page 13

assessed their overall impact, as any commercial party would. The GIC should take the same approach on appeal when considering whether our decision was one that no reasonable pipeline provider would make. It is a mistake not to stand back and assess the overall significance of the concerns explained by Vector.

Vector's reasons for its decision

Reason 1: problem is insufficient to warrant the proposed response

- 20 One of the considerations we weighed when assessing Contact's Change Request is that the problems associated with package requests are not significant, and the GIC has been handling the potential downsides of package requests in a practical way.
- 21 As the GIC notes in the Draft Recommendation, Vector is not saying that package requests present no issues. But it is relevant that they are few in number, and that the GIC has been able to address the concerns that have been expressed thus far.
- 22 The Draft Recommendation agrees with this assessment, but concludes this is not a reasonable ground for withholding consent. However this is an example of where the atomistic analysis of the individual considerations leads the GIC astray.
- 23 The point is not just that package requests are few in number and the GIC is dealing with them. The broader point is that a realistic assessment of the scale of any problem needs to be assessed against the real world effects of the proposed changes to the contract. In this case, the proposed change would result in material costs, disputes and delay (discussed below in reasons 2 and 5) and reduce the ability of the contracting parties to advance meaningful reform to the open access scheme on Vector's pipeline (discussed below in reasons 3 and 4).
- 24 Vector disagrees with the observation in the Draft Recommendation that significance can be attached to the fact that all but one shipper voted for Contact's Change Request. Reasonableness is not a head counting exercise. The GIC has been given the appeal role because it is not only independent, but familiar with the industry dynamics. It will be aware that there will be times when a reasonable pipeline owner will reasonably make decisions to withhold consent to changes promoted by a shipper that all other shippers may see private advantage in.

Reason 2: the proposed change would create inefficiencies

Reason 5: the proposed change would create disputes and delay

- 25 Reasons 2 and 5 for withholding consent relate to difficulties we see with the proposed changes to the VTC. Vector is concerned that the proposed change to define and require "single issue" change requests would:
- 25.1 Increase the number of change requests, thereby requiring Vector (and interested shippers) to commit more resources to preparing or responding to change requests, and participating in appeals; and
- 25.2 Create a platform for a whole new area of dispute, cost, arbitration and delay.
- 26 By its very nature, Contact's Change Request seeks to require several change requests and processes where there would otherwise be one. The Draft Recommendation attempts to down play the level of cost and time commitment this would impose on parties. We disagree with how this would play out in

practice. Replacing one change request with two or three change requests, and two or three processes and two or three appeals, will inevitably impose further costs on the industry for the same result.

- 27 The Draft Recommendation speculates that the quality of the outcome may be better by running two or three processes and appeals rather than one. This is on the basis that parties may be able to avoid situations where they believe they need to "vote tactically", and give an accurate view of the merits of the proposed change. The Draft Recommendation speculates that this might reduce the number of appeals.
- 28 Vector disagrees with this framing. Parties give accurate information to the GIC currently, and the GIC deals well with so-called package requests, as set out in our previous submission.
- 29 In summary, the additional cost to assess a number of single change requests for the same changes would be inefficient.
- 30 These additional costs will be increased by a degree of magnitude with the proposal to attempt to define a "single issue" and a "related series of issues". As discussed in the context of our Reason 5, attempting to draw this line would be a quixotic task, and result in the change request process becoming even more legalistic and disputatious.
- 31 An example is the Balancing Arrangements Change Request that motivated Contact's Change Request. Contact has referred to the Balancing Arrangements Change Request as an example of a package request, when Contact is aware that Vector does not agree with that characterisation. All of the changes included in the Balancing Arrangements Change Request were directed at addressing the same substantive flaw in the open access arrangements. It is telling that a change request of this nature is sufficient to give rise to a dispute over the meaning of "single issue" or "series of related issues" or "package request".
- 32 A further example is a change request that Vector recently received from Mighty River Power (*MRP*). In a letter dated 26 July 2013, MRP submitted a change request which proposed changes to the VTC "to implement a B2B balancing framework and the new Peaking Charge". While MRP is probably of the view that these are "related issues" (having given its consent to the Change Request that is the subject of this appeal), a party who did not support this change might dispute this on the basis that balancing and peaking are quite distinct processes. And clearly there are good arguments either way – illustrating the futility of this definitional exercise and the near certainty that it will add a further layer of potential disputes.
- 33 Inefficiencies would also arise from having to submit individual change requests for minor clause reference changes or typos in the VTC. Even if Contact's recommended wording in section 25.4 included an exception for "minor changes", there would inevitably be a battle over what constitutes a "minor change".
- 34 In short, the proposal to put a "single issue" filter on the change request process would result in the process becoming more of a play thing for lawyers than it is already. The uncertainty in any definition would result in disputes (tactical or genuine), arbitration, cost and delay that does not exist in the system currently.

- 35 As the GIC acknowledges:
- 35.1 "there seems a reasonable prospect of legitimate dispute over whether change requests fulfil the requisite single issue criteria";
 - 35.2 "the parties may be required to take disputes about the scope of a change request to a court or other arbiter";
 - 35.3 Contact's Change Request "opens up the possibility that the Single Request criteria will become a tactical tool used to frustrate and stall the implementation of VTC amendments"; and
 - 35.4 "there is a material risk that such issues could have a material adverse impact on the ability of VTC parties to make legitimate amendments to the VTC".
- 36 These statements highlight the concerns Vector weighed in reasons 2 and 5; the proposed changes create the obvious potential for parties to incur greater costs, either in needing to formulate and assess a greater number of change requests, and / or working through disputes and arbitration over the single request condition.
- 37 It was not unreasonable for Vector to weigh these significant potential costs to the changes proposed against the small scale of the so-called package change request issue and decide to withhold consent to Contact's Change Request.
- 38 As discussed below, we also weighed the potential for the proposed changes to remove a valuable form of flexibility which the parties currently have to advance changes in the open access regime on Vector's pipeline.
- Reason 3: the proposal would reduce the ability to negotiate changes***
Reason 4: the proposal would hinder implementation of market reforms
- 39 Reasons 3 and 4 for withholding consent relate to concerns about the loss of flexibility that could result from the proposed changes. Vector can envisage some scenarios where the ability to have a package of loosely related changes is beneficial to the working of the VTC.
- 40 The discussion in the Draft Recommendation of when a package change request might be useful is insufficient. Vector raised the implementation of the PEA reforms as an example (reason 4). The GIC needs to bear in mind the current commercial context for change requests when thinking about how these reforms might get implemented (and how the implementation could get derailed). It is wholly insufficient to assert that simply because the parties have agreed on a package of changes to the VTC, the method of implementing those changes doesn't matter.
- 41 Using the PEA reforms as an example, some resulting change proposals will be advantageous to shippers, some will not. Vector will be in the same position. Both Vector and shippers will want certainty that the agreed package is implemented as a whole. Vector does not expect any party, including Vector, to support proceeding by way of a series of single change requests. No party will take the risk that particular aspects of the agreed package of reforms might get "picked off" as the proposed changes are processed one by one. If that is the proposed

method of implementation, Vector's expectation is that the agreed reforms will not get off the start line.

- 42 A similar dynamic is likely to prevail in more general negotiations over changes to the open access regime on Vector's pipeline. The nature of commercial negotiations is that they are a horse-trade, unconstrained by definitions of "single issue" or "related series of issues". Parties will have different issues they want addressed, and if changes are to proceed by way of agreement (and we are to aspire to fewer appeals) then changes will occasionally proceed as agreed packages.
- 43 More generally, in the current commercial context where shippers often have competing interests, one or two shippers can veto a change request and Vector must consent (not acting unreasonably), we can envisage scenarios where practical progress could rely on change requests that bring together a package participants can live with (and that promotes the Gas Act objectives and the GPS).
- 44 Again, however, the fact that a package is agreed does not make the process for implementing the VTC changes irrelevant. If changes can only proceed by way of single issue changes, parties would be required to accept the risk that changes they see as a "give" make it through the process, but "takes" do not. Commercial parties won't run that risk and progress will not get made.
- 45 For this reason, Vector also weighed the potential loss of valuable procedural flexibility when deciding to withhold consent for Contact's Change Request. It was not unreasonable to do so.
- 46 To some degree, this description of current and likely behaviour reflects the imperfect state of the current VTC change request process. As we discuss below, hopefully the change request process can be reformed in the near future to improve engagement and outcomes. With five years' experience we now have the opportunity to make a set of co-ordinated changes to the change request process. But amending the process by ad hoc change request on appeal to the GIC, to contest the reasonable decision of the infrastructure provider, is not the right way to proceed.

Standing back

- 47 Looking at all of the reasons put forward by Vector as a whole, it is clear that Vector was not objectively unreasonable in withholding its consent to Contact's Change Request. The difficulties that would be created by the Change Request are material and the GIC is dealing with any package change requests in a practical way.

APPEAL ON THE MERITS

Vector's position on the available appeal rights

- 48 The GIC has invited comment on Appeal Ground 2. Vector's position is that an appeal under section 25.6(c) is not available where Vector has declined consent.
- 49 To allow a merits appeal under section 25.6(c) in a scenario such as this would make redundant:

49.1 The requirement for Vector to consent to a change to the VTC;

49.2 The requirement that Vector not unreasonably withhold its consent; and

49.3 The ability of a shipper to test whether Vector's decision to withhold consent was unreasonable.

50 If a change request can pass on merit appeal regardless of whether Vector's consent is reasonable, then these features of the VTC serve no purpose. On the face of the VTC, this clearly cannot have been the intention of the parties.

51 This aligns with Vector's understanding of the working of the contract. It is an important feature of the contractual open access regime on our pipeline that proposed changes to the VTC can only happen with our consent. We accept that shippers have the safeguard that we cannot unreasonably withhold our consent, and we have promised not to do that. We cannot accept an interpretation that now purports to render that balance of rights on this important topic redundant.

This appeal

52 Vector also queries whether the so-called "second appeal" was properly advanced. Contact's appeal relates entirely to the decision to withhold consent, except for a single reference to "and (c)".

53 It is clear that Contact's letter dated 31 May 2013 was drafted on the understanding (that we share) that the appeal is under section 25.6(a). The five page letter discusses only Vector's decision to withhold consent. Under the heading "Basis for Appeal", Contact identifies only section 25.6(a).

54 There is no discussion of the issues that would need to be addressed on a merits appeal. There is no mention of the Gas Act objectives or the GPS. No material is put in front of the GIC that is relevant to a merit appeal, let alone to discharge the onus on an appellant. The reference to "and (c)" in paragraph 1.4 seems to have been an afterthought.

Role of the GIC

55 If Contact's 31 May 2013 letter is sufficient to amount to a position on the interpretation of the VTC, then Vector agrees there is a dispute on contractual interpretation.

56 Vector agrees that it is not the GIC's role to deciding disputes of contractual interpretation. That is not the role provided for in the VTC.

57 The contrast here is with the GIC's role on Appeal Ground 1. Assessing whether Vector's decision to withhold consent was objectively unreasonable requires the application of a legal test, rather than engaging in contract law analysis.

ISSUES WITH THE CHANGE REQUEST PROCESS

58 There are wider issues with the change request process. It is not functioning in a way that might be expected in a self-negotiating / multi-party contract context.

59 There is no incentive on any party to engage on drafting points, or even to consider the change request, until the last moment. Problems with the operation of the contract, and proposed solutions, are not worked through in advance of a party activating the formal change process. Once submitted, and parties focus on the problem definition and potential solutions, there is no ability to amend a

change request. There are also real issues regarding how to deal with overlapping change requests from different parties, often conflicting. As a measure of the poor process, all recent change requests have either been abandoned or appealed.

The way forward

- 60 The July 2013 PEA report recommended that the MPOC and VTC governance arrangements be reviewed. Any lack of clarity as to the appeal structure in the VTC should be picked up in this process (and Vector supports that happening).
- 61 In summary, the change request process would benefit from a wider, more deliberated set of changes, rather than a mechanically problematic ad hoc change which targets a peripheral issue. In reviewing the governance arrangements, Vector proposes to advocate for a more comprehensive contract change process to address some of these issues.

Yours sincerely



Brenda Talacek
Transmission Commercial Manager