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7 October 2011

Paul Mitchell
Chief Advisor
Regulation Branch
Commerce Commission
P.O. Box 2351
Wellington

Dear Paul,

Cross-submission on the Setting of Starting Pricings for Gas Pipeline Businesses under the Initial Default Price-Quality Path Discussion Paper

Public Version

Introduction

1. Vector welcomes the opportunity to make a cross-submission in respect of the Discussion Paper "Setting of Starting Prices for Gas Pipeline Businesses under the Initial Default Price-Quality Path" (GPB SPA Discussion Paper), dated 22 August 2011. Vector has provided a confidential and a public version of this submission. Confidential information is marked (**[ ] VCI**).

2. Vector generally agrees with the submissions made by other parties. We note our support, in particular, for MGUG's view that "With respect to information required to set starting prices we form the view that the role of the Commission is to provide a reasonableness check on GTB's routine budgeting processes rather than to also prescribe methodology for projecting revenue, opex, and capex." We also agree with MGUG's view that "In Vector's case that includes their 2010/11 financial year."

3. Vector disagrees with MGUG's view that the Commission should set starting prices based on the current and projected profitability of each supplier, and that Vector's Gas Transmission Business (GTB) should be subject to a revenue or a price cap.

Section 52P(3)(a) versus (b)

4. MGUG have argued that the Commission should adopt section 52P(3)(b) on the grounds that section 52P(3)(a) "risks either having insufficient incentives to invest/ innovate by GPBs, or fails the test of sharing the efficiency gains, including lower prices with consumers." Vector has commented on the choice between section 52P(3)(a) and (b) in detail in our submissions to the Commission. We additionally note that:

    a. MGUG are justified to have concerns about ensuring there are sufficient incentives to invest and innovate. This is a concern Vector has consistently raised with the Commission.

    b. In the context of section 52P(3) this concern only warrants consideration of subpart (b) where a Gas Pipeline Business (GPB)'s current and projected profits (including margin for error) are insufficient for it to earn a commercially sustainable rate of return. Even then the Commission should assure itself that GPB is not operating at a loss (return below WACC) because of inefficiency, that can be addressed through cost reductions.

c. The other observations we have is that sharing of efficiency gains can and is normally done through the setting of X factors in CPI-X style regulation, and the Commission's proposed approach to section 52P(3)(b) risks de facto rate of return outcomes. If the latter proves to be the case the extent of ongoing efficiency gains that can be shared with consumers will be suppressed.

Revenue cap versus price cap

5. MGUG's arguments in favour of a price cap for Vector's GTB hinge on arguments that contain factual errors.

6. MGUG has argued that "Electricity generators, responsible for most of the annual fluctuations in demand, for example are subject to a fixed capacity fee only so that Vector's revenue is fixed regardless of how much gas is used by them."

7. This is incorrect.

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9.

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10. Regardless capacity reservation fees are in themselves variable. If there is excess supply in the electricity generation market, and if the marginal generators have fuel costs (ie non hydro/geothermal) it would be reasonable to expect that these types of power stations will seek to re-negotiate their contracts and reduce load. If this occurred during a Gas Year, Vector would suffer a loss of revenue.

11. If MGUG's views about demand for Vector's gas transmission demand were correct, then Vector could potentially be financially better off under a price cap. The fact that Vector prefers the Commission to adopt a revenue cap for its GTB, trading off potential upside from demand growth for lower risk, should accordingly be seen as a strong signal that Vector has genuine concerns about revenue uncertainty, regardless of the extent to which past revenue has been stable. MGUG have separately argued that "GTBs should have a better understanding of their core business than the Commission". The Commission should accept this logic and apply it to the matter of a revenue cap versus price cap.

Concluding remarks

12. Vector reiterates our view that prices should be set in accordance with section 52P(3)(a) of the Commerce Act and our support for the Commission's decision to impose a revenue cap on Vector's GTB.

13. If the Authority has any queries regarding Vector's submission or would like further information please contact me on 09 978 8340 or allan.carvell@vector.co.nz.

Kind regards

Allan Carvell
Group General Manager Regulation and Pricing