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John McLaren
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Sent by email to: regulation.branch@comcom.govt.nz

Dear John,

Implementation of the Default Price-Quality Path for Gas Pipeline Services

Introduction

1. Vector welcomes the opportunity to respond to the Commerce Commission's (Commission) consultation paper *How we propose to implement the Default Price-Quality Path for Gas Pipeline Services*, dated 8 February 2013. No part of this submission is confidential.
2. Vector's contact person for this submission is:

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Price Path

Pass-through and recoverable costs

Use of lagged pass-through and recoverable costs

3. Vector **supports** the use of lagged pass-through and recoverable costs for the price path determination. This removes the need to forecast these costs and hence removes the risk that a forecasting error could lead to a price-path breach or an under-recovery of allowable revenues. We would support this approach also being applied for electricity distribution providing that suitable

allowances are also included for the time value of money and noting that pass-through costs in electricity tend to be significantly more material.

Treatment of pass-through and recoverable costs not yet reflected in prices

4. Vector has considered the options presented by the Commission for addressing unrecovered pass-through and recoverable costs from previous regulatory periods.
5. Vector considers that there is a more practicable alternative to the two options proposed by the Commission. Vector **recommends** the Commission rely on the Director representation and audit processes within the determination to provide the necessary assurance that the costs are accurate. This is instead of the Commission formally approving each cost.
6. In relation to the Auckland gas network, as noted in our Weighted Average Price Compliance Statement in our response to the December 2012 53ZD notice, Vector has included the actual and forecast pass through cost (differences) up to 30 September 2013 in prices from 1 October 2012. On this basis, it is likely that any unrecovered pass-through costs will result from either new definitions of pass-through and recoverable costs, or costs that were not anticipated. These are likely to be easy to explain for the former and small and non-material for the latter. Therefore, a reliance on the Director representation and audit processes is appropriate for approving the pass-through costs.
7. Vector's second preference is for the Commission's second option (i.e. approval of the costs). We believe this would be more workable than the Commission expects due to the likely small or easily identifiable nature of the costs, as discussed above.
8. Vector does not support the Commission's preferred option (a formula to estimate the pass-through cost amounts). This is because Vector has multiple gas distribution networks of which only some were subject to the Gas Authorisation. Any approach to incorporate unrecovered pass-through costs in prices will need to be able to be applied to only part of a GDB's regulated gas network.
9. The Commission's preferred option does not appear to consider this and it is not clear how it would work in practice. For example, prices, pass-through costs and quantities would all need to be specified with respect to the part of the network previously subject to the Authorisation.

Balancing gas costs

10. Vector **supports** the Commission's proposal to allow businesses not previously subject to the Gas Authorisations to recover costs associated with balancing gas that have not yet been reflected in prices.

11. The Commission proposes three options to enable suppliers to recover previously incurred balancing gas costs. Vector's **preference** is for the third of the options listed; i.e. before the end of the first assessment period the Commission would use data obtained under section 53ZD to determine an adjustment to the amount each supplier can recover under the DPPs. This option provides the greatest degree of certainty that the outstanding amounts can be recovered.

Gas distribution clause 11.4 – price restructuring

12. Vector has concerns regarding this clause as it appears to both require unnecessary information and misunderstand the nature of the price path. We welcome the recent helpful discussions with the Commission on this clause and would be happy to provide further information if required.
13. The clause requires GDBs to "...provide sufficient information to demonstrate that the restructuring did not increase **allowable notional revenue** above that which would have applied..." [emphasis added]. This is not workable. It is not possible for a price restructuring that occurs during year t to increase allowable notional revenue, which is determined by prices in year t-1 and quantities in year t-2. We believe the Commission means "notional revenue" rather than "allowable notional revenue".
14. However, we have raised this issue in previous submissions and Compliance Statements¹ and the Commission has not adjusted the clause. If the Commission decides to retain the current wording, Vector **recommends** the Commission provides clarification of how this clause should operate given the issue raised above.
15. If it is agreed that clause 11.4 should refer to notional revenue rather than allowable notional revenue then the requirement within it adds an unnecessary additional compliance burden within the DPP. It would require a GDB to demonstrate that the restructuring did not increase notional revenue more than would have applied without the restructuring. However, the DPP already requires notional revenue to be less than allowable notional revenue. If the revenue that would be recovered before the restructure is less than the cap, why should the GDB be prevented from increasing its revenue as a result of the restructure as long as it remains within the cap?
16. To address the issues raised above, Vector **recommends** the following drafting is applied instead:

¹ For example: Vector Limited, *Implementation of the Proposed Reset of the 2010-15 Default Price-Quality Path*, 26 November 2012, pages 3-4. Vector Limited, *Submission to the Commerce Commission on Revised Draft Decision on the Initial Default Price-Quality Path for Gas Pipeline Services*, 6 December 2012, paragraph 185.

11.4 If a GDB has restructured its prices during an assessment period and prices in year t no longer relate to quantities in year t-2, then the GDB must provide sufficient information to demonstrate how the GDB has complied with the price path in Clause 8 including:

11.4.1 the methodology used to determine the quantities in year t-2 that correspond to the restructured prices.

17. We believe this drafting will address the issue the Commission is concerned about, without confusing matters by trying to apply a requirement to the definition of allowable notional revenue. If this recommendation is adopted, clause 11.5 could be deleted.
18. Clause 11.4 also requires estimates of quantities for the assessment period and the two prior pricing periods. It is not clear why the Commission requires quantity information for anything other than the quantity period lagged by 2 years (t-2). Requiring the additional information is inconsistent with the price path, which deals solely with notional, not actual, revenue. Pricing methodology disclosures under the Information Disclosure Determinations require target revenue to be disclosed. Vector considers that the pricing methodology is a more appropriate place for consideration of the actual revenue that a GDB expects, incorporating the implications of price restructuring. Vector **recommends** the Commission does not require this quantity information to be provided. This paragraph and recommendation also applies to clause 11.4 in the GTB determination.

Gas distribution Schedule 6: claw back

19. The term CR_t is not defined clearly. Vector **recommends** the first sentence of step 1 of the schedule is amended to read:

The claw-back required for each of the periods (a) to (e) below *is* CR_t and is calculated using Equation 6: [new wording in *italics*]

20. Overall Vector considers this schedule to be excessively complicated and difficult to use. In addition, the requirement to calculate the claw-back amount for each year (or part year) separately rather than the entire period from 1 January 2008 is inconsistent with section 55F(2). Section 55F(2) simply permits the Commission to apply claw-back if prices increase by more than CPI over the period from 1 July 2008 to the date of the DPP determination. Whether prices increase by more than CPI in any particular year is not relevant provided they remain under the CPI "cap" over the entire period.
21. As a more straightforward approach that is also more consistent with the Act, Vector **recommends** the following formula:

$$\text{TCR} = \frac{\sum P_{2013} Q_{2008} - (K_{2013} + V_{2013}) - (\sum P_{2008} Q_{2008} - (K_{2008} + V_{2008}))}{\text{CPI}_{2013}/\text{CPI}_{2008}} *$$

22. TCR could then be amortised back as a recoverable cost using the $(\text{TCR}/4.5) * (1+r)^n$ formula.
23. However, Vector reiterates the statement made in Vector's Weighted Average Price Compliance Statement for the response to the 17 December 2012 53ZD notices that we have complied with the weighted average price requirements of section 55F(2). The compliance statement demonstrated that weighted average prices for Vector's gas pipeline businesses have not increased by more than the forecast movement in CPI between 1 January 2008 and 30 September 2013.²

Constant price revenue growth (gas distribution)

24. Vector believes the application of constant price revenue growth has been incorrectly applied in GDB Equation 3. There appears to be a bracket missing, with the effect that constant price revenue growth only applies to the sum of pass through and recoverable costs and not ANR_{2013} . Vector assumes this is not intentional and **recommends** an extra closing bracket prior to the CPR_{2012} term.
25. Vector is also concerned that when Table 3 is populated CPR_{2012} will include a number greater than 1 and not a fraction, i.e. CPR_{2012} should **not** be expressed on the same basis as ΔCPR_t as described in Equation 9.

Quality standard

Definition of emergency

Gas transmission services definition of emergency

26. Vector agrees with the intent of the proposed definition of emergencies for gas transmission businesses (GTBs). We welcome the engagement we have had with the Commission on this issue since the consultation on the draft decision was completed. However, we believe the drafting could be further improved. The words "the incident" at the end of the definition are unnecessary because the reference to "an incident" at the start of the definition is sufficient to link the definition to an incident. Also, the definition

² We also refer the Commission to *our Submission on Initial Default Price-Quality Path for Gas Pipeline Businesses: Issues Paper*, 14 May 2010, paragraphs 8-15. This submission raised concerns that the Commission was "proposing to apply claw-back of revenue earned on the basis of an Assessment Methodology that was not notified to suppliers before the revenue was earned". The concerns raised in that submission are heightened given the extremely short timeframe between the new claw-back proposals made in this consultation and the end of the period to which section 55F(2) applies.

contains two tests which would be easier to read if they were set out separately.

27. Vector **recommends** the following revised definition is used:

emergency means an incident that:

(a) is, or will be, reported under the 'Guidelines for a Certificate of Fitness for High-Pressure Gas and Liquids Transmission Pipelines'; and

(b) the **GTB** considers a representative of the **GTB** is required to immediately respond to

Gas distribution services definition of emergency

28. Vector agrees with the intent of the definition of emergency for gas distribution businesses (GDBs), but believes the drafting could be improved. In particular:

- a. Clause (a) contains a typo: "emergencies service". This should read "emergency service".
- b. Clause (b) states "emergency means an unplanned interruption or disruption in the supply of gas arising from ... an unplanned disruption". It is not meaningful to say that an unplanned disruption arises from an unplanned disruption.
- c. Clause (c) states "emergency means an unplanned interruption or disruption in the supply of gas arising from ... evacuating premises as the result of escape or ignition of gas". This implies that it is the evacuation that causes the interruption, when in fact it will be the other way round.

29. Vector **recommends** the following definition, which has the same meaning as the Commission's version but is more clearly drafted:

emergency means an unplanned interruption or disruption in the supply of gas–

- (a) arising from an unplanned escape or ignition of gas that requires the active involvement of any emergency service (i.e., fire service, ambulance); or
- (b) affecting more than five installation control points (ICPs); or
- (c) causing the evacuation of premises as the result of escape or ignition of gas;

General comments

Compliance Statements

30. Vector strongly welcomes the Commission's intent to only require an *ex post* Compliance Statement, rather than an *ex post* and an *ex ante* Compliance Statement as previously proposed. This will substantially lessen the compliance burden for gas pipeline businesses (GPBs).
31. Vector also welcomes the Commission's decision to require Compliance Statements to be submitted 50 working days after the end of each assessment period, rather than two months after as in the previous draft.

Legal costs for 2011 year

32. The Commission proposes to exclude the legal costs of appeals under Part 4 from forecast operating costs.³ This is on the basis that section 52T(1)(c)(i) prevents those costs from being passed-through to prices.
33. Vector does not agree with the Commission's proposal or their interpretation of the section. The wording of section 52T(1)(c)(i) clearly does not prevent legal costs of Part 4 appeals being included in forecast operating costs. In particular, the section relates only to "pass-through costs" which are distinct from operating costs.
34. This has been recognised by the Commission where it has specified distinct "pass-through costs" in accordance with section 52T(1)(c)(i) in clauses 3.1.2 and 3.1.3 of the IM Determinations but has not specified any operating costs in accordance with that section.
35. The Commission has also previously expressed the view that the prohibition on passing legal costs through to prices in section 52T(1)(c)(i) applied only to pass-through costs:

"Pass-through costs are specifically identified under s 52T(1)(c)(i). Under that section, **pass through costs** cannot include the legal costs of any appeals against input methodology determinations under Part 4, or of any appeals under s 91 or s 97.⁴ [emphasis added]

36. No analysis is provided in the consultation paper to justify the Commission's change in position.
37. From a policy perspective, Vector also believes that it makes sense for Parliament to exclude legal costs from pass-through costs but not operating

³ Consultation paper, paragraph 3.21.

⁴ Commerce Commission, *Input Methodologies Discussion Paper*, 19 June 2009, paragraph 4.99 and 12.313 (the same statement was made twice).

costs. This is because suppliers have a measure of control over their legal costs so it is appropriate for efficiency incentives to apply to them. If legal costs for merits review appeals were included in pass-through costs rather than baseline operating costs, suppliers would have no incentives to achieve efficiencies in those costs (where such incentives are important in the context of merits review appeals).

38. If legal costs of input methodology appeals were to be excluded from operating costs, then suppliers may be rendered unable to challenge an input methodology decision as they would be unable to afford the legal fees. This would have the effect of denying them access to the appeal rights provided under Part 4, which cannot have been Parliament's intention. Legal costs are a legitimate part of a firm's expenditure and should not be treated differently.
39. Further:
 - a. the Commission is required to apply its IM Determinations when determining DPP prices under s 52S(b)(ii);
 - b. "operating costs" in the IM Determinations is defined as:
 - operating cost means a cost incurred by the [GDB] in question relating to the supply of-
 - (a) regulated services alone; or
 - (b) regulated services and one or more unregulated service,and excludes-
 - (c) a cost that is treated as a cost of an asset by GAAP;
 - (d) amounts that are depreciation, tax, subvention payments, revaluations or an interest expense, in accordance with their meanings under GAAP;
 - (e) pass-through costs; and
 - (f) recoverable costs;
 - c. This definition of "operating cost" clearly includes Part 4 appeal costs.
40. In summary, the Commission is not required by the Act to exclude these costs from the baseline opex of regulated suppliers. To the contrary, the Commission is required to apply the definition of "operating costs" in its IM Determinations, which includes the legal costs of Part 4 appeals.

Transactions

41. The requirement to notify the Commission of large transactions has been retained from previous drafts. Given the new clauses that provide more detailed requirements for demonstrating price and quality compliance following a transaction, it is not clear that clause 10.6 of the GDB determination or clause 10.3 (second time that number is used) of the GTB determination are still required. It would be helpful if the Commission could clarify why it needs this information in advance and what it would do in response to such information being provided.

Other comments on the drafting of the determinations

42. More detailed comments on the drafting of the determinations are set out in the table below.

Clause/schedule/item	Comment
Definition of quantities	Vector welcomes the change to this definition since the previous consultation. The new definition is a significant improvement.
GDB clause 8.1	This clause states that starting prices are set out in Schedule 1. However, schedule 1 does not contain any prices (as "prices" is defined) and instead sets out the maximum allowable revenues.
GTB clause 8.1	This clause states that starting prices are set out in Schedule 2. However, schedule 2 does not contain any prices (as "prices" is defined) and instead sets out the maximum allowable revenues.
GDB clause 8.3	This clause discusses allowable notional revenue determined under "this clause". However, clause 8.3 does not specify what allowable notional revenue is. The drafting of this clause in the previous consultation draft was better. Vector recommends the previous wording is used: Allowable notional revenue (ANRt) specifies the maximum prices that may be charged during an assessment period.
GTB clause 8.3	This clause discusses allowable notional revenue determined under "this clause". However, clause 8.3 does not specify what allowable notional revenue is and ANR cannot specify maximum actual revenues as these will depend on the actual

	<p>quantities during the assessment period. Vector recommends the following wording is used:</p> <p style="padding-left: 40px;">Allowable notional revenue specifies the maximum notional revenues that may be recovered during an assessment period.</p>
GDB clause 8.4	The allowable notional revenue term is partially bolded but should not be bold.
GDB clause 8.5.1	There are two clauses numbered 8.5.1. The second should be 8.5.2.
GTB clause 8.5.1	The "n" in the definition of "t" should not be in italics.
GDB and GTB clause 9.4.2	The words "was greater than" should not be in bold.
GTB clauses 10.1, 10.2 and 10.3	The draft determination contains two clauses with each of these numbers.
GTB clause 10.3 (first one)	This clause refers to Schedule 7 but should refer to Schedule 8.
GDB clauses 10.3 and 10.4	These clauses are almost identical. Only one of these clauses is required. Clause 10.4 also contains extraneous wording that is more relevant to gas transmission (e.g. "welded party").
GDB clause 10.6.2 and GTB clause 10.2.2	These clauses refer to a GDB/GTB demonstrating it has complied with clause 9. However, the clauses only apply to transactions specified in clause 10.3 and have no effect on quality information. Therefore the clauses should not refer to clause 9.
GDB clause 10.7.1 and GTB clause 10.3.1	These clauses include the term "regulatory value", but this term is undefined. Should this be "regulatory investment value"?
GTB clauses 10.3.1 and 10.3.2	These clauses refer to "gas distribution services". This should be "gas transmission services".
GTB clauses 11.4 and 11.5	These clauses refer to "GDB". This should be "GTB".
GDB clause 11.5	This clause refers to a revenue forecast. However, the price path compliance test is <i>ex post</i> and the impact on actual revenue could be demonstrated.

	Vector recommends the word "forecast" is deleted from this clause.
GDB Schedules	There is an Equation 2, but no Equation 1.
GDB Schedule 4 and GTB Schedule 5	In these clauses "first assessment period" is not correctly bolded in the first sentence.
GTB Schedule 5	In this clause, the definition of ANRt should read "the allowable notional revenue for the pricing period <i>ending in year t</i> " [additional words in <i>italics</i>].

Yours sincerely,



Bruce Girdwood
Manager Regulatory Affairs