Submission to the Commerce Commission on Revised Draft Decision on the Initial Default Price-Quality Path for Gas Pipeline Services

6 December 2012

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INTRODUCTION

1. Vector welcomes the opportunity to submit on the Commerce Commission's (Commission) consultation paper *Revised Draft Decision on the Initial Default Price-Quality Paths for Gas Pipeline Services*, dated 24 October 2012 (consultation paper).

2. This submission is supported by reports from Competition Economists Group (CEG) and Castalia, which we attach.

3. Vector would welcome the opportunity to assist the Commission and its staff with understanding any of the points made in this submission.

4. Vector's contact person for this submission is:

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5. Vector's submission and the attached consultancy reports are not confidential.

6. This submission is made without prejudice to the merit review and question of law appeals currently being heard in the High Court.

EXECUTIVE SUMMARY

Opening comments

7. This draft decision comes towards the end of a long process but there remains scope for the Commission to improve its forecasts and modelling.

8. Overall, it is critical that the Commission provides sufficient funds to ensure that gas pipeline businesses (GPBs) have the incentives and ability to invest in their networks. Robust infrastructure has implications for public safety and security of supply, delivering substantial spill-over benefits to the public.

Base year

9. Vector supports the use of a single year's base year. We note the Commission's view that 2012 opex data could also be used in this decision and we support this proposal also. It would be possible to provide IM-compliant opex data for 2012 in time for the price reset decision. Using the most recent opex figure available should better reflect the opex requirements of GPBs.

Adjustments to RAB based on NeI Report

10. As discussed with the Commission on 23 November 2012, Vector believes the changes made to the RAB value of Vector distribution are erroneous and/or unjustified. The EV and optimisation adjustments by Vector are in accordance with the IMs and, if they were disallowed, would lead to an increase in Vector's gas distribution RAB.

11. Linepack, in our view, should be included in Vector's RAB. In addition, the analysis of the disallowed optimisation and economic value write down is incorrect.

Unaccounted for gas

12. Vector's view is that the purchase of unaccounted for gas is the same thing as purchase of balancing gas, i.e. gas to rebalance the linepack in the pipeline. Hence UFG costs are also recoverable costs under the gas transmission business (GTB) input methodology (IM). On this basis, Vector may need to resubmit some 53ZD data.

Forecasts

Inconsistent forecasts

13. The Commission uses different gas throughput forecasts in different parts of its model. The model uses a declining volume trend to forecast opex and an increasing volume trend to forecast revenues. This approach is inconsistent and unjustifiably penalises suppliers.

Opex

14. The Commission's opex forecasts systematically understate the actual opex requirements across the industry.

15. Vector's assets are ageing and to maintain/repair them to safe and reliable standards will result in cost increases. The Commission should provide an allowance that reflects the cost of managing aging assets. To ensure these costs can be met, the Commission should rely on supplier forecasts when setting opex allowances.

16. The Commission proposes to forecast changes in opex for gas distribution businesses (GDB) in part based on changes in network scale. These network scale effects are based on an Ofgem study of UK gas distributors from 2006-

2007. As discussed by Castalia, there are substantial differences between the UK and New Zealand/Australian gas distribution sector which make the reliance on the Ofgem study unsafe.

17. Castalia has conducted an alternative study using more recent Australian and New Zealand data on the relationship between opex and network scale. This concludes that a network scale factor of 0.9758 would be more appropriate for New Zealand gas distributors. Vector supports the Castalia approach to establishing opex elasticity for GDBs.

Revenue growth

18. Vector appreciates that the Commission has used the Concept Report to develop demand forecasts as there are few other relevant information sources available at the present time. However, we note the qualification stated in the Concept Report:

> It is important to emphasise that **these price scenarios are not forecasts**. Rather, they represent alternative 'futures' that could unfold over the 2012-2027 period. They are deliberately **structured to span the broad range of outcomes that could plausibly emerge** in this timeframe.[1] [emphasis added]

19. The Concept Report forecasts gas demand to grow by 0.6% per year on average. If historic trends are considered a different picture emerges. Total throughput on Vector's gas distribution system has fallen by 1.97% per annum over the 2005-2011 period, closer to the Concept tight scenario and we consider the tight scenario to be a more reasonable forecast.

20. The Commission's proposal to assume that commercial customers' growth rates will be equal to the average of TOU and non-TOU growth rates in the Concept report is unsound. The data and discussion in the Concept report demonstrates that all TOU and some non-TOU customers are industrial, meaning that the commercial growth rate should be equal to the non-TOU growth rate.

Capex

21. The Commission's proposed cap on the capex allowance of 20% above historic trends is arbitrary and unjustified. The Commission has previously stated that:

> historical levels of capex are not necessarily a good predictor of future levels of capex unless we make adjustments to take into account factors such as the age of the asset base.[2]

22. If a cap is to be introduced, a better approach would be to base it on the rate of "stay in business" capex. A sound proxy for this would be the rate of depreciation of the RAB. There is no reason to see capex that keeps pace with depreciation as excessive or an aberration as it is a reasonable assumption that capex will shadow depreciation over time.

Price path

23. Vector opposes the proposal to require GPBs to demonstrate compliance with clause 8.4 twice for the same year (under 11.2.1 and 11.2.3). Both compliance reports are subject to audit and GPB auditors would need to review the calculations twice. This proposal creates unnecessary costs and confusion and does not provide sufficient time for the information required to be disclosed.

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[1] Concept Report, page 29.

[2] Commerce Commission, *Additional Input Methodologies for Default Price-Quality Paths: Process and Issues Paper*, 9 December 2011, paragraph 164.

24. In principle, the DPP should allow GPBs to pass through/recover costs without cost or disadvantage and to minimise the risk of non-compliance. The Commission's proposal does not achieve this. The lag in recovery of the pass through costs (particularly balancing gas costs) imposes a time value of money cost on GPBs. This should be offset by a use of money adjustment, as was provided for in the Gas Authorisation.[3]

Quality standards

25. Vector considers that the Commission's proposed definition of emergency for GTBs is a definition of incidents rather than emergencies. Many events that are not emergencies will be captured by the definition and GTBs will be required to attend within 180 minutes even though there is no safety or operational reason to do so. GTBs are not resourced to meet this requirement and, as drafted, the Commission's quality standard for GTBs is both nonsensical and unachievable.

26. Vector welcomes the Commission's proposal to allow for exemptions from the 180 minute emergency response time requirement where events occur outside of the suppliers' control. We believe certainty would be improved by specifying up front a list of circumstances in which exemptions would be provided.

[3] Commerce Act (Vector Natural Gas Services) Authorisation 2008.

OPENING COMMENTS

27. This draft decision comes towards the end of a long process of consultation and debate and the draft decision will implement some decisions that have already been made (i.e. input methodologies). However, there remains scope for the Commission to improve the robustness and accuracy of its forecasts and modelling of current and projected profitability.

28. It is critical that the Commission provides sufficient funds to ensure that gas pipeline businesses (GPBs) have the incentives and ability to invest in their networks. Investment ensures that the gas pipeline infrastructure, which is part of the national critical infrastructure, is robust and able to be operated in compliance with safety and quality standards. Robust infrastructure has benefits in terms of:

    a. public safety (by reducing the probability of failures with the potential to cause injuries or loss of life); and

    b. supply reliability (by minimising the potential for unplanned outages and ensuring that supply can be restored quickly following outages).

29. The importance of robust infrastructure was demonstrated vividly by the 2011 outage on the Maui Pipeline, which has led to an increased focus on the need for investment and has highlighted the severe economic cost that can occur as a result of an unplanned disruption to New Zealand's gas transportation system (the cost of the outage was estimated at $40 million per day, or $200 million across the five day outage).[4]

30. The Commission's gas reset decision should also be considered in the context of its previous Part 4 inquiry into gas pipeline pricing. The inquiry resulted in the Commission determining that there was no need for price control of gas transmission while Vector's Auckland network gas distribution charges were cut by over 20% in real terms from 2005 and Vector's gas pipeline prices have been effectively capped at inflation from 2008 under section 55F(2) of the Commerce Act 1986 (the Act).

31. If the Commission is to successfully meet its statutory objective under Part 4 of the Commerce Act it needs to ensure that regulated suppliers can reasonably expect to recover a commercially realistic return on their investments, both sunk and future, having regard to the global financial crisis, ongoing market volatility and the long-term nature of investment in network infrastructure. Unfortunately, we do not believe this draft decision delivers such an outcome.

[4] Ministry of Business, Innovation and Employment, *Review of the Maui Pipeline Outage of October 2011*, October 2012, page 26.

PRICE RESET MODEL

Base year - overall

32. The Commission proposes to use 2011 as the sole base year for the price reset. Vector agrees that the use of a single year base year is appropriate for this price reset decision.

Base year - opex

33. In paragraph C10 of the consultation paper, the Commission invites views on whether the year ending 2012 should be used for the base year "if this information is available in time for the final decision". Given the placing of this comment within the consultation paper, we assume the Commission is suggesting using 2012 as the opex base year but using 2011 information to set the base year elsewhere in the final decision.

34. Vector **supports** this approach. It will not be possible to provide a full set of IM-compliant 2012 data in time to inform the Commission's final price reset decision if that is to be made by 28 February 2013. However, it would be possible to provide IM-compliant opex data for 2012 in time for this decision. Using the most recent opex figure available should better reflect the opex requirements of GPBs.

35. Vector **recommends** the Commission use 2012 data to set the opex base year and issues a 53ZD notice to require 2012 opex data only from GPBs. We expect that Vector would be able to provide audited and Board-approved 2012 opex data by early February 2013, subject to sufficient notice being given to GPBs of the request.

RAB adjustments based on the Nel report

36. The opening RAB value included within the draft decision for Vector's gas businesses are lower than those provided by Vector in the 53ZD notices. We understand this is due to adjustments removed on the advice of Nel Consulting Ltd. Vector believes the changes made to Vector's RAB values are erroneous and/or unjustified.

Optimisation and economic value adjustments

37. According to the report by Nel Consulting Ltd a total value of $3.277 million of adjustments to the gas distribution RAB should be disallowed. According to the Nel report this value is made up of:

    a. $0.642 million – Intangible assets deemed to be non-compliant (2005 dollars)

    b. $2.635 million – optimisation and economic value write down deemed to be non-compliant (2003 dollars)

38. As discussed with the Commission on 23 November 2012, the calculation of the disallowed optimisation and economic value write down is incorrect.

39. The initial Vector adjustment report clearly explains that the revised optimisation and economic value write down is not an adjustment as defined in the 2010 Input Methodologies. On the contrary, as per the rules of the Input Methodologies, Vector employed the same optimisation and economic value tests used in the historical valuation to determine the "modified values" of the adjusted asset register. The revised figures are made up of the following:

    a. revised optimisation decreased by $535,765 (i.e. $4,327,479 before vs. $3,791,714 after); and

b. revised economic value write down increased by $2,099,542 (i.e. $2,819,029 before vs. $4,918,571 after.

40. The net effect of these two revised values is a decrease in the RAB of $1,563,777 (i.e. decreased optimisation of $535,765 **minus** increased economic value write down of $2,099,542). Disallowing these revised values therefore increases the RAB. The Nel report incorrectly assumed that both revised values resulted in a disallowed uplift totalling $2.635 million (i.e. optimisation of $535,765 **plus** economic write down of $2,099,542)

41. If these revised values are disallowed, the total impact of the disallowment, including the disallowed intangible assets of $642,000, should therefore be an increase in the RAB of $921,777, not a decrease of $3.277 million.

42. However, in discussion with the Commission on 23 November 2012, the Commission indicated that they no longer intended to disallow the revised economic value write down. As indicated by Vector by email on the same day,[5] the disallowed optimisation followed exactly the same approach as the disallowed economic value write down discussed at the meeting. Similar to economic value write down, the optimisation methodology was unadjusted and should therefore not be disallowed. In other words, the two revised values should be treated in the same way. Consequently, Vector **recommends** that the only disallowed adjustment should be the intellectual property at $642k.

43. Vector also **requests** that the Commission responds to Vector's previous correspondence on this matter.

Line pack

44. Vector **recommends** the adjustment we proposed to Vector Transmission's RAB regarding line pack be allowed. Line pack is the volume of residual gas contained within the pipeline system, necessary in order to maintain pressure in the network, and therefore required for the operation of the network. Line pack, to the value of $1.429 million, was included in the RAB effective on 30 June 2007 when the ownership of line pack transferred from the Vector Gas Wholesale Group to the Vector Gas Transmission business. Vector will engage further with the Commission on this matter in the near future.

Unaccounted for gas

45. UFG is the difference between what is received into a pipeline, less offtakes, changes in line-pack, fuel gas and gas vented (on the transmission pipeline, UFG is normally the result of gas metering uncertainties). Pursuant to the Vector Transmission Code, UFG forms part of Vector's Imbalance. Vector is required to purchase gas to correct this imbalance from time to time.

46. The gas transmission IMs provide that "a cost or credit arising from the GTB's purchase or sale of balancing gas that has not been allocated to a person shipping gas on the GTB's network" is a recoverable cost.[6] Vector has recently reviewed this clause and reached the view that the purchase of UFG is the purchase of balancing gas, i.e. gas to rebalance the linepack in the pipeline. Hence UFG costs are also recoverable costs.

47. We discussed this matter with the Commission on 23 November 2012 to seek confirmation that the Commission agreed with this interpretation but we have not

[5] Email from Ian Ferguson to Matthew Lewer, Vector Gas Distribution RAB – Optimisation disallowed, 23 November 2012, 10.51am.

[6] Commerce Act (Gas Transmission Services Input Methodologies) Determination 2010, clause 3.1.3(c).

yet received a response. We are happy to provide the Commission with further information to support our interpretation if that would be helpful.

48. If the Commission agrees that UFG costs can be treated as recoverable costs, Vector would need to re-submit some 53ZD data. This is because in our response to the gas transmission 53ZD notice we included UFG costs as opex. We now consider they should be included in the recoverable cost line item.

49. Vector **recommends** the Commission agrees that UFG costs are balancing gas costs and facilitates a process for Vector to re-submit the relevant 53ZD information.[7]

Financial hardship

50. As discussed by Castalia,[8] in theory there should be no need for allowances for financial hardship provided a regulator sets a price path that permits the firm to recover its efficient costs over the regulatory period. However, in reality, debt and equity markets are not perfect and do not have infinite liquidity. These imperfections mean that it is quite possible for an economically viable price path to fail to maintain a viable capital structure, particularly during periods of financial instability.

51. As discussed by Castalia:[9]

> The Commission's forecasting methodology for capital and operating expenditure results in estimates that are significantly lower than supplier forecasts, and high constant price revenue estimates.
>
> The combination of the large differences when compared with supplier forecasts and concerns with forecasting approaches combine to create a new financeability risk if the Commission's forecasts are wrong. If, for example, the capital that is actually needed to maintain reliability levels and service standards is closer to supplier estimates than the Commission's forecast, then it is unlikely that sufficient capital can be raised from either debt or equity investors to undertake the needed investment.

52. Vector **endorses** Castalia's recommendation that the Commission should conduct financeability checks using pro forma information to ensure the financeability of their decisions.

Modelling interest deductions for tax purposes

53. We refer the Commission to the section in the CEG report on this topic. As explained by CEG, the Commission's proposed approach to modelling costs as if they are incurred in the middle of the year is inconsistent with its treatment of interest tax deductions.[10] Vector **recommends** the Commission adopt CEG's recommendation for resolving this issue.

Other regulated income

54. Vector **supports** the Commission's draft decision to set other regulated income equal to zero for Vector. The other regulated income received by Vector's gas transmission business in 2011 was from two one-off payments that are not expected to recur.

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[7] If the Commission agrees to use 2012 opex data in its final decision, the disclosed 2012 opex data will reflect the decision on how to treat UFG costs.
[8] Castalia Advisors, Review of the Draft Decision on the Revised Initial Price-Quality Paths for Gas Pipeline Services: Report to Vector Limited, December 2012, page 26.
[9] ibid, page 27.
[10] CEG, *Default price-quality path reset for gas pipelines*, November 2012, section 5.1.

FORECASTING APPROACHES

Systematic bias

55. As in the EDB draft decision, the Commission has asserted that its "modelling of operating expenditure and revenue relies on independent forecasts that are free of systematic bias, in either direction".[11] Vector **recommends** the Commission provides evidence to substantiate this assertion before it relies upon it in the final decision. The issue highlighted in the next paragraph may suggest the modelling contains systematic bias against GPBs.

Consistency of forecasts

56. Vector notes that the Commission has used different forecasts of opex in different parts of its model. It has:

    a. forecast volume-related opex growth using declining gas volume trends sourced from information disclosure; at the same time as

    b. forecast revenue growth using increasing gas volumes, based on the Concept Report.

57. As CEG points out,[12] these are clearly inconsistent and assume that Vector requires less revenue as lower volumes are leading to lower opex while also needing lower prices because higher volumes are leading to higher revenues. Vector **recommends** consistent data sets are used within the model, in particular the same volume forecast should be used for opex and revenue growth forecasts.

Opex forecast

Supplier forecasts should be given more weight

58. The Commission's operating expenditure (opex) forecasts provide allowances that are below the forecasts provided by all regulated GPBs, in some cases by large margins. This suggests that the Commission's approach to forecasting opex systematically understates the actual opex requirements across the industry and indicates a need for significant revision of the Commission's opex forecasts in the final decision. Vector also considers that this undermines the Commission's assertion that all regulated suppliers will expect to earn at least normal returns under the DPP.

59. Vector finds the Commission's reluctance to rely on supplier-provided forecasts surprising as the Commission is willing to rely on supplier-provided capex forecasts (albeit with a cap) and supplier-provided forecasts of increased insurance costs. It is unclear why the opex forecasts provided by suppliers are considered to be less reliable.

60. The Commission asserts in paragraph C5.2 that opex "can be easily modelled because it is typically recurring and has a reasonably stable trend". Vector notes that shocks can occur to disrupt the stability of the opex trends and these need to be catered for. A good example is the outage of the Maui pipeline that occurred in 2011. Such events can lead to a reassessment of the necessary amount of opex required to provide gas pipeline services and hence lead to shifts in opex that do not reflect historical trends.

61. For example, following the GNS report on the Maui Pipeline outage, Vector developed plans to conduct extensive land stability investigations in relation to its

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[11] Consultation paper, paragraph 6.4.1.

[12] CEG, *Default price-quality path reset for gas pipelines*, November 2012, paragraphs 13-15.

own pipelines and install measuring and communications equipment that could provide early indication of pipeline strain. Activities to manage the risk of land movement will need to be an increased part of how Vector operates its pipeline businesses in the future, rather than a one-of cost directly associated with the incident.

62. The cost of complying with pipeline standards is also increasing. To ensure assets remain compliant with standards and regulations, e.g. the new versions of AS2885, NZS7901 and electrical regulations, additional costs are anticipated.

63. Overall, Vector's assets are aging and to maintain/repair them to safe and reliable standards will result in cost increases. The Commission should provide an opex allowance that reflects the cost of managing aging assets. It is also important to recognise that if capex investment in renewal/replacement of assets is not at sufficient levels the cost of opex to maintain/repair will increase.

64. All of these factors point to increasing operating expenses over time that are not sufficiently catered for in the Commission's opex allowance. Vector **recommends** the Commission use supplier-provided forecasts to project opex in its final decision.

Opex growth drivers

65. The discussion in this section is set out as Vector's second-preference option, in case the Commission does not set its opex forecasts equal to the forecasts provided by suppliers.

Network scale for GTBs

66. For GTBs, the Commission has made the assumption that network scale factors do not affect opex. Vector can advise that we are not aware of any clear correlation between changes in Vector's gas transmission opex and changes in pipeline length, customer numbers or gas volumes.

67. Vector therefore **agrees** that, for gas transmission, an elasticity of zero is reasonable in the DPP context. We also agree it is unlikely to be possible to estimate elasticities based on the available information.

Network scale for GDBs

68. The Commission has made the assumption that the key network driver of opex for GDBs is network scale, based on an average of network length and the number of customers. Vector **agrees** these are valid drivers of GDB opex.

69. The Commission has further assumed that the impact of these drivers within New Zealand will be the same as that found in a study by Ofgem of the UK gas sector in 2007. As discussed by Castalia, there are substantial differences between the UK and New Zealand/Australian gas distribution sector which make the reliance on the Ofgem study unsafe.[13] For example, UK gas networks are much more extensive, reflecting the overall higher levels of population density throughout the UK.

70. More broadly, Vector is concerned that the Commission appears to have taken a single piece of analysis from a report of an overseas regulator and inserted it into the model without much analysis or consideration of the context from which it was taken. The Commission does not appear to have considered any other

[13] Castalia Advisors, Review of the Draft Decision on the Revised Initial Price-Quality Paths for Gas Pipeline Services: Report to Vector Limited, December 2012, pages 9-10.

options for assessing elasticity and in our view has not demonstrated that the use of the Ofgem data is appropriate, let alone the best approach.

71. Castalia has conducted an alternative study using more recent Australian and New Zealand data on the relationship between opex and network scale. This concludes that a network scale factor of 0.9758 would be more appropriate for New Zealand gas distributors.[14]

72. Vector **recommends** the Commission base the opex elasticity on Castalia's analysis of the relationship between opex and network scale for New Zealand and Australian gas distributors.

Allowance for increased insurance costs

73. Vector **supports** the Commission's draft decision to include an adjustment for increased insurance costs resulting from recent natural disasters, including the Canterbury earthquakes. As the Commission notes, these cost increases arise from an industry-wide event, are largely outside the control of suppliers and are unlikely to be captured in models of operating expenditure for each supplier.

Constant Price Revenue Growth forecasts

Reliance on the Concept Report

74. Vector appreciates that the Commission has used the Concept Report to develop demand forecasts as there are few other relevant information sources available at the present time. Vector agrees that there is unlikely to be a clear correlation between GDP or population growth and gas demand.

75. In our view, demand forecasts are inevitably going to contain errors. It is therefore essential to understand the distribution of forecast errors and what these errors mean for suppliers' ability to earn a normal return.

76. In that context, we note the qualification stated in the Concept Report:

> It is important to emphasise that **these price scenarios are not forecasts**. Rather, they represent alternative 'futures' that could unfold over the 2012-2027 period. They are deliberately **structured to span the broad range of outcomes that could plausibly emerge** in this timeframe.[15] [emphasis added]

77. Further, we note that the Concept Report relied on by the Commission is a draft report. The reliance on asset valuations developed using a draft ODV handbook has been a long-standing matter of controversy between GPBs and the Commission. Reliance on another draft document to set prices is undesirable and the Commission should apply a high threshold before relying on draft analysis.

78. Even if a final version of the report and modelling is published in time to be used in the Commission's final starting price adjustment decision for GPBs, the report was subject to an inadequate consultation period of just 12 days on the report and 6 days on the modelling data. Only four submissions were received, of which the longest (by Vector) was just four pages. The Concept Report should not, therefore, be taken as having industry support or as having been subject to proper peer review by affected stakeholders.

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[14] Castalia Advisors, Review of the Draft Decision on the Revised Initial Price-Quality Paths for Gas Pipeline Services: Report to Vector Limited, December 2012, page 10.

[15] Concept Report, page 29.

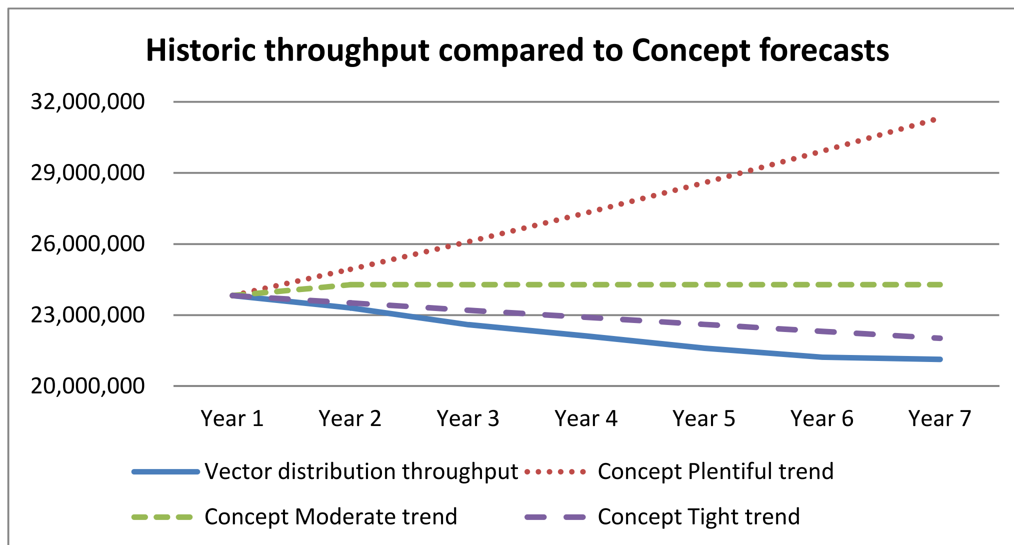
79. As a result, we **recommend** that the Commission exercises caution when adopting any of the scenarios in the Concept Report without assessing how well they reconcile to other available data.

Comparison of Commission's proposal to historical trends

80. The Concept Report forecasts overall gas demand to grow by 0.6% per year on average. A different picture emerges if historical trends are considered. As demonstrated by information disclosed under the Gas (Information Disclosure) Regulations 1997, total throughput on Vector's gas distribution system has fallen every year since 2005 (prior to 2005 data is more difficult to reconcile given the purchase of NGC). On average, demand fell by 1.97% per annum over the 2005-2011 period. This compares to the Commission's weighted average forecast growth for Vector's gas distribution business of 1.14%.

81. The graph below shows the historical trend in Vector's gas distribution throughput to be below even the Concept tight scenario. This highlights the risk that reliance on Concept plentiful or moderate scenarios in particular will overstate the amount of revenue likely to be achieved by GPBs.

Figure 1: Comparison of Concept forecasts to historical trend experienced by Vector's gas distribution business



82. A similar trend is identified by Castalia utilising data from the Ministry of Business, Innovation and Employment, which "shows a progressive fall in both commercial and residential gas demand since 2009".[16]

83. Further, as noted by Castalia,[17] demand for reticulated gas is also influenced by its discretionary nature, consumer tastes and the price of substitute energy choices (i.e. electricity, LPG). There are also downside demand risks facing Vector which we have limited ability to mitigate. These factors all suggest that there is a high risk that any optimistic plentiful trend (i.e. high demand/low gas price) scenario may not be realised.

84. As a result it does not seem obvious that future gas prices will be in the region of Concept's plentiful trend scenario.

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[16] Castalia Advisors, Review of the Draft Decision on the Revised Initial Price-Quality Paths for Gas Pipeline Services: Report to Vector Limited, December 2012, page 20.

[17] ibid, page 23.

85. If the Commission relies on the Concept Report, Vector **recommends** it utilises the tight trend scenario as this best fits with other available data.

Allocation of Concept forecasts to customer groups

86. The Commission proposes to allocate Concept's TOU forecast to industrial demand growth and Concept's non-TOU forecast to residential demand growth. Commercial demand growth, not forecast by Concept, is assumed to be the average of TOU and non-TOU demand growth. This assumption is not supported by the draft Concept Report. We refer the Commission to page 59 of the Report which states:

> **TOU customers are industrial customers** with demands typically greater than 10TJ per annum, whereas **non-TOU customers are predominantly mass-market small customers (both residential and small business)**. [emphasis added]

87. Further, on page 35 of their draft Report, Concept notes that "residential demand accounted for only 3.5% of total New Zealand consumption in 2011". However, based on the data supporting the Concept Report, non-TOU demand made up more than 10% of total demand in 2011 and other years. Thus, by definition, the non-TOU segment cannot only be made up of residential customers.

88. Further, as noted by CEG,[18] some of Vector's industrial customers are also likely to be included in the "non-TOU" category as the data used in the Commission's modelling indicates that nearly 66% of total distribution volume demand is from industrial customers and only 50.4% of demand falls within the TOU category across the North Island.

89. These factors suggest that the "commercial" category should be allocated to the non-TOU category in its entirety, rather than its current 50% weighting and a portion of the industrial category should be allocated to the non-TOU category. If the Commission chooses to rely on the Concept Report in its final decision, Vector **recommends** the growth forecast for commercial customers is based on non-TOU growth rates. Vector **recommends** a portion of industrial customers is also allocated to the non-TOU category. CEG provide further analysis in support of this approach.[19]

Use of historical trends for customer numbers

90. The Commission proposes to forecast change in customer numbers for distribution based on the historical trend between 2008 and 2011. Vector **supports** this approach.

Gas transmission base year gas demand

91. The Commission's Revised Gas Draft Decision Constant Price Revenue Growth Projections Model includes an Actual TJ gas throughput Vector transmission number for 2011 (cell C37 of Revenue Model_Transmission tab). This number has been derived from the Concept Report. However, Vector has already provided the Commission with actual throughput data for Vector's gas transmission business and considers that this information should be used instead to set the base year.

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[18] CEG, *Default price-quality path reset for gas pipelines*, November 2012, section 2.2.
[19] ibid

92. Vector **recommends** the Commission sets 2011 Vector transmission throughput equal to the value in cell M14 of Schedule C of the 53ZD notice data provided to the Commission on 31 August 2012.

Capital expenditure forecasts

93. The Commission proposes to base capital expenditure on forecasts provided by regulated suppliers, but with a cap at 20% of average historical expenditure. The implication of this is that neither Vector transmission nor MDL will be able to carry out their full capex programme without accepting sub-normal returns. We **note** that when 100% of the gas transmission sector would need to apply for a CPP to meet their own capex needs, it is difficult to sustain the view the current DPP settings are appropriate. The Commission's approach effectively disincentivises DPPs, which in our view is contrary to the intent of the Act.

Supplier forecasts capped at 120% of historical spend

94. Vector submits that the Commission's proposed cap on the capex allowance of 20% above historic trends is arbitrary and unjustified. Even if a cap is necessary, no analysis appears to have been done to identify that 20% is the optimal limit. The imposition of a cap will have implications for expenditure by GTBs and hence on the quality of supply experienced by gas users in New Zealand.

95. Vector also notes the Commission's previous statement that:

> historical levels of capex are not necessarily a good predictor of future levels of capex unless we make adjustments to take into account factors such as the age of the asset base.[20]

96. The Commission assumes GPBs will apply for a CPP if necessary but, as discussed in detail in previous submissions,[21] this approach:

    a. is based on a systematic under-estimation of the degree of risk regulated suppliers perceive from a CPP application;

    b. is contrary to the intended operation of the CPP / DPP framework, where the DPP should accommodate most suppliers with the CPP limited to material step changes in capex (not "stay in business" capex); and

    c. appears to be increasingly relied on as a reason for not fully engaging with the development of a DPP that best meets the Part 4 purpose.

97. We also find it curious that the Commission has invited submissions on whether the 20% cap is too high, but does not allow for the possibility that it may be too low.[22]

98. If a cap is to be introduced, a better approach would be to base it on the rate of "stay in business" capex rather than an arbitrary percentage – i.e. to set it on the basis of what a GPB needs to maintain their business at its current state. A sound proxy for this would be the rate of depreciation of the RAB. There is no reason to see capex that keeps pace with depreciation as excessive or an aberration as it is a reasonable assumption that capex will shadow depreciation

[20] Commerce Commission, *Additional Input Methodologies for Default Price-Quality Paths: Process and Issues Paper*, 9 December 2011, paragraph 164.
[21] For example, Vector Limited, *Submission to the Commerce Commission on Revised Draft Reset of the 2010-15 Default Price Quality Paths for Electricity Distribution Businesses*, 1 October 2012, paragraphs 169-185. Vector Limited, *Submission to Commerce Commission on 2010-15 DPP Starting Price Adjustment and Other Amendments Update Paper*, 16 May 2011, paragraphs 94-106.
[22] Consultation paper, paragraph B12.

over time. Vector **recommends** that, if a cap is set on capex forecasts, it is set at the limit of RAB depreciation.

99. If the Commission retains a cap, Vector **recommends** it discloses the analysis undertaken to assess what level of cap was appropriate.

100. Vector also endorses the analysis of CEG that:[23]

> In our view, the Commission's proposal does not distinguish between new and replacement capital expenditure, and by failing to do so is likely to require a customised price path for businesses to get "stay in business" capex plans approved by the Commission. A default price path that cannot achieve even this must be regarded as very ineffective.

101. As is further noted by CEG,[24] where the Commission's methodology has made significant reductions to capital expenditure forecasts, the depreciation modelled by the Commission is consistent with much higher levels of capital expenditure than those allowed by the Commission.

Effect of the cap on capex efficiencies

102. The Commission has also expressed concern that absence of a cap "may reduce the incentives to achieve capex efficiencies (a supplier can earn an acceptable return without achieving efficiencies)" and "it may allow the supplier to undertake more capex than is required and valued by customers".[25] Vector has the following observations about these claims:

    a. The Commission should be more concerned about under-investment than over-investment, given the former will have the greatest negative impact on consumers and the economy (as growth-driving investment will be reduced);

    b. Regulated suppliers will have incentive to achieve capex efficiencies because this will allow them to earn greater returns; and

    c. Regulated suppliers only have incentives "to undertake more capex than is required and valued by customers" where the Commission has set an inflated WACC (Averch-Johnson effect). As is demonstrated by recent merits review appeals, regulated suppliers believe the WACC is too low, so they will not have this incentive.

Forecasting incentive mechanism

103. Castalia recommends introducing a mechanism similar to the Information Quality Incentive scheme operated by Ofgem.[26] This mechanism allows suppliers to choose between (a) lower capex forecasts with higher incentives, and (b) higher capex forecasts but with lower incentives so they keep less if they underspend.

104. Vector supports this recommendation. We understand that it may not be feasible to develop such a scheme in time to be implemented in 2013, but we **recommend** that the Commission publicly commits to introducing a form of forecasting incentive for GPBs by the start of the next regulatory period.

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[23] CEG, *Default price-quality path reset for gas pipelines*, November 2012, paragraph 28.
[24] ibid, paragraph 40.
[25] Consultation paper, footnote 111.
[26] Castalia Advisors, Review of the Draft Decision on the Revised Initial Price-Quality Paths for Gas Pipeline Services: Report to Vector Limited, December 2012, pages 13-18.

Non-network capex

105. The Commission proposes to set the non-network capex allowance for GPBs based on historical trends in expenditure. Vector **supports** this approach as the best option currently available.

PRICE PATH

Due dates for compliance statements

106. The Commission's draft decision is that compliance statements will be required two months after:

    a. the start of the pricing year to demonstrate compliance with the price path; and

    b. the end of the pricing year to demonstrate compliance with the quality standard.

107. Vector strongly opposes this proposal.

108. It is unclear to Vector why there is a need to detach the price and quality compliance statements for the same year and why the Commission does not propose to follow the approach utilised for EDBs.

109. The Commission then proposes to require GPBs to demonstrate compliance with clause 8.4 twice for the same year (under 11.2.1 and 11.2.3). Both are subject to audit and GPB auditors would need to review the calculations twice. Hence audit costs would increase. A single compliance statement at the end of the year would be more efficient and less costly. The Commission's statement in paragraph L8.2 of the consultation paper that more timely information on compliance is of value to interested persons is weak – there is no evidence or analysis provided of why interested parties need this information in advance of most of the regulatory year.

110. The proposal causes further problems in that other definitions within the determination no longer make sense (e.g. $Q1_{,t-2}$, as the year referred to is no longer two years earlier).

111. Finally, two months is not a sufficient timeframe to gather all necessary data, conduct an audit and secure directors' sign-off of the compliance statements.

112. Overall, the Commission's proposal creates unnecessary costs, creates confusion as different approaches are applied to different regulated businesses and some definitions now do not work, and does not provide sufficient time for the information required to be disclosed. We urge the Commission to reconsider this proposal.

113. Vector **recommends** the approach applied to EDBs be similarly applied to GPBs and a combined price and quality compliance statement is required 50 working days after the end of the pricing year. If the Commission does not accept this recommendation, Vector **recommends** the Commission provide 50 working days for the separate compliance statements to be developed.

Industry-wide rate of change

114. Vector **agrees** with the Commission's proposal that the industry-wide X-factor be set at 0%.

115. Vector read with interest the Commission's analysis at paragraph 4.5 of the consultation paper which concludes that whatever level the X-factor is set at has no effect on the present value of the revenue expected by regulated suppliers. This is because the Commission's current approach to starting price adjustment modelling approach sets a starting price such that estimated costs equal estimated revenues over the regulatory period. Any change to the X-factor

would be offset by an equivalent change to the starting price adjustment and simply changes the shape of revenues over the regulatory period. In this context there would be little value in expending resources on detailed assessments of industry productivity.

116. However, the Commission's current approach may be inconsistent with section 53P(6) of the Act which requires that the rate of change be based on the long-run average productivity improvement rate of suppliers in New Zealand or comparable countries. It may be contrary to the Act to set a rate of change that has no meaningful effect on consumer prices as it renders section 53P(6) redundant. A modelling approach that allows the rate of change to impact end prices directly (rather than through adjustments such as the opex partial productivity factor) may be required by the Act.

117. Vector **recommends** the Commission considers whether its price reset modelling approach meets the requirements of the Act with regards to the rate of change.

Price cap for gas distribution businesses

118. Vector **supports** the Commission's draft decision that gas distribution businesses be subject to a price cap.

Revenue cap for gas transmission businesses

119. For the reasons set out in some detail in a previous submission,[27] Vector **supports** the Commission's draft decision that gas transmission businesses be subject to a revenue cap.

Erroneous reference to 2012/13 prices

120. Equation 3 of the GDB draft determination seeks to set allowable notional revenue for 2013/14. It does so by inflating 2012/13 prices and 2011/12 quantities by CPI (the equation has other elements that are not relevant here). As discussed with the Commission on 23 November 2012, this equation does not deliver the Commission's intent. That is because 2012/13 prices are the GDB's actual prices for that year, not the calculated MAR for that year. As such, applying equation 3 as set out in the draft determination would not achieve the Commission's intended price reset decision.

Length of regulatory period

121. The Commission proposes to introduce a four year and three month regulatory period, lasting from 1 July 2013 to 30 September 2017. Vector **supports** the Commission's proposal.

15 month initial assessment period

122. The Commission proposes that the first assessment period within the gas DPP will be 15 months. Vector **agrees** that this is preferable to an approach in which GPBs would be required to demonstrate compliance with price and quality standards over the initial three months in a separate exercise. A combined 15-month assessment period will reduce audit costs.

Changes to prices (clause 8.5)

123. Vector **recommends** clause 8.5 is deleted from both the GDB and GTB determinations. It is not clear what the intention is behind clause 8.5 or why it

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[27] Vector Limited, *Submission on the Commerce Commission's Initial Default Price-Quality Path for Gas Pipeline Businesses: Discussion Paper*, 27 May 2011, paragraphs 28-51.

requires clause 8.4 to be assessed as if the changed prices applied for the entire assessment period.

124. Under clause 8.5 a GPB could reduce prices on the last day of the year (with no effect on revenue) and would then have to demonstrate the effect of this change to the Commission as if the lower price were in effect for the full year. It is not clear why this would be necessary. However, it also enables GPBs to apply that lower price in subsequent compliance statements, creating perverse incentives to arbitrage the price path requirements.

CPI definition

125. The definition of ΔCPI uses the incorrect subscript for the December quarters. They should be one year earlier than stated in the definition; i.e. $CPI_{Dec,t-1}$ should be $CPI_{Dec,t-2}$ and $CPI_{Dec,t-2}$ should be $CPI_{Dec,t-3}$. We **recommend** this definition is amended.

Pass through and recoverable costs

126. In principle, the DPP should allow GPBs to pass through/recover costs without cost or disadvantage and to minimise the risk of non-compliance. The Commission's proposal does not achieve this. The lag in recovery of the pass through costs (particularly balancing gas costs) imposes a time value of money cost on GPBs. Vector **recommends** this is offset by a use of money adjustment, as was provided for in the Gas Authorisation.

127. An alternative is to pass through/recover the costs closer to the date they are incurred (as is done for the EDB DPP, which uses forecasts of pass through and recoverable costs when setting prices), although this does increase the risk of non-compliance. Or the Commission could even allow GPBs to determine for themselves when they include pass through and recoverable costs in the price path, providing they are actual costs. Vector **recommends** the Commission consider these options.

Definition of quantity

128. The definition of quantity in the GDB DPP determination is inconsistent with the definition of quantities in the GDB IM (clause 3.1.1(5)). Vector considers that these definitions should be consistent. Indeed, the Commission is required to apply the relevant IMs when determining the DPP (under section 52S of the Act). Vector **recommends** the DPP determination use the IM definition of quantity.

Claw-back

129. The Commission has described a process for applying claw-back to GasNet and has set out the relevant claw-back formulas in Box L9. The Commission has also indicated they would use this same approach for calculating claw-back where GPBs have increased weighted average prices for the period 1 October 2012 to 28 February 2013 by more than CPI.

130. The application of the approach outlined in Box L9 to Vector is likely to cause problems for Vector's Auckland gas distribution network because the approach in Box L9 is different from the way prices were set under the Gas Authorisation. This primarily arises in relation to the way CPI and pass-through costs are treated between the Gas Authorisation and the revised draft decision:

   a. The CPI under the Gas Authorisation used a weighted average calculation of CPI with the latest quarter used being the March t-2 quarter. The draft

decision claw-back formula uses an annual (single index) calculation between the September t and September t-1 quarters.

b. Pass through costs under the Gas Authorisation were based on the difference between pass through costs that were certain (i.e. where Vector had been invoiced or given notice of the cost) and the amount of pass through costs included in allowed revenue as specified by the Commission. Compliance required reversal of prior year pass through cost differences (between certain and specified pass through costs) and the application of current year differences. These differences could relate to pass through costs from several years prior. By contrast the draft decision claw-back formula simply uses actual pass through costs in that period.

131. The claw-back formula should require only that portion of weighted average prices in excess of those allowed under the Gas Authorisation to be included as a recoverable cost, including an adjustment for the time value of money. The formulas in Box L9 will need to be amended to be more consistent with the requirements of the Gas Authorisation, including addressing the issues above, for this to be achieved.

QUALITY STANDARDS

Response times to emergencies

132. Vector **supports** the use of emergency response times as the sole quality standard for GPBs in the first regulatory period. We agree it may be desirable to amend the quality standard in the next reset when more data is available to support the derivation of other potential measures.

Potential future reliability measures

133. Vector notes the Commission's statement that, for future resets, it would prefer to set quality standards based on reliability levels for each supplier, because the Commission considers "reliability as the most important measure of the level of service that suppliers should be providing to meet the quality demanded by their consumers".[28] The Commission goes on to indicate in footnote 65 that SAIDI and SAIFI are likely to be considered in greater detail.

134. Vector agrees that reliability is important but we strongly believe that, for gas in particular, safety considerations are paramount. There is little value in providing a reliable but unsafe supply of gas. Further, as noted in previous submissions,[29] the frequency of SAIDI and SAIFI outages is so low for gas that setting a non-volatile and statistically meaningful target is not likely to be achievable. The Commission should not introduce any quality standards that are not reasonably achievable by regulated suppliers, nor any quality standards that are not meaningful to regulated supplier as in the operation of the regulated business.

Definition of emergency for GTBs

135. Vector considers that the Commission's proposed definition of emergency for GTBs is too broad and will lead to unintended and perverse consequences. The Commission's suggested definition is:

> **emergency** means an incident report that is required recorded by the GTB's emergency management system as required by the Department of Labour 'Guidelines for a Certificate of Fitness for High-Pressure Gas and Liquids Transmission Pipelines' 2002 that requires a representative of the gas transmission businesses to attend the site of the incident;

The proposed definition would capture events that are not emergencies

136. The problem with the definition is that it is based on an incident/investigation reporting system, not an emergency system. Generally, an incident is defined as an unwanted event, so all emergencies are incidents but not all incidents are emergencies. The definition would capture emergency events but also other non-emergency incidents.

137. The Department of Labour Guidelines also have a relatively light focus on a loss of supply situation, which we consider is undesirable for an emergency definition.

138. The Commission's proposed definition would capture events that, while it is necessary for a GTB representative to attend the site of the event, are not generally considered to be emergencies within the industry. For many events captured by the above definition there is no need to attend the site within three hours for any safety or operational reason; although attendance is required it is

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[28] Consultation paper, paragraph 5.5.

[29] For example, Vector Limited, *Submission on the Commerce Commission's Initial Default Price-Quality Path for Gas Pipeline Businesses: Discussion Paper*, 27 May 2011, page 17. Vector Limited, *Submission on Initial Default Price-Quality Path for Gas Pipeline Businesses: Issues Paper*, 14 May 2010, pages 8-9.

less urgent. Examples of cases where the definition would require us to respond within 180 minutes include:

a. line heater outage (a line heater heats the gas prior to pressure reduction to prevent freezing);

b. gas chromatograph fault (a gas chromatograph is an analytical device for measuring the composition of the gas);

c. flow computer fault (a flow computer coupled with a meter determines the flow of gas);

d. general communications fault (communications equipment relates to data being supplied to the SCADA system);

e. compressor non start (compressors are used to compress the gas and thereby boost gas movement);

f. regulator stream where a standby has malfunctioned (regulators are mechanical devices that reduce pressure in the system generally just prior to transfer to the customer).

139. These events are incidents which require a response, but there is no operational or safety reason to necessarily respond to them within 180 minutes. Nor are gas transmission operators resourced to respond to such events within that timeframe. The Commission's quality standard, as drafted, is both nonsensical and unachievable.

The proposed definition is inconsistent with previous intentions

140. In our view, the proposed definition is inconsistent with the Commission's intentions expressed in previous consultation papers that:

> The Commission's current view is that one quality standard should apply to GPBs for the Initial DPP and that this should be related to safety[30]
>
> We have decided to set an upper limit because without one, there may be a reduced incentive on a pipeline operator to attend to an event promptly if it has taken, or will likely take, longer than 60 minutes to reach the site of the emergency. We believe the setting of an upper limit better promotes the Part 4 Purpose, in particular s 52A(1)(b).[31]

141. The Commission's previous analysis of the quality standard for GPBs clearly demonstrated a clear aim to incentivise promote safety and prompt responses to emergencies. The current proposed definition undermines these aims by including non-safety and non-emergency information within the quality standard requirement. This is undesirable.

The quality standard should not be based on a desire to increase the number of data points

142. We also note that the Commission has proposed its definition for GTBs because "transmission businesses face fewer callouts from emergency services and we,

[30] Commerce Commission, *Initial Default Price-Quality Path for Gas Pipeline Businesses: Discussion Paper*, 1 April 2011, paragraph 7.28.
[31] Commerce Commission, *Initial Default Price-Quality Paths for Gas Pipeline Businesses: Draft Reasons Paper*, 21 November 2011, paragraph 4.28

therefore, consider that the proposed definition better captures their day to day responsiveness".[32]

143. It appears from this that the Commission is setting a quality standard for GTBs designed to increase the number of data points in the sample rather than to promote sensible operational procedures. Increased data points are not necessary when the target is 100% compliance.

Vector's recommended alternative definition of emergency

144. As an alternative definition, Vector **recommends**:

> *For transmission businesses "emergency" means an incident reported under the "Guidelines for a Certificate of Fitness for High- Pressure Gas and Liquids Transmission Pipelines" that poses an immediate risk to health, life, property or environment or is a material unplanned supply interruption to consumers.*

145. This definition has been developed by Vector's technical engineering experts and we consider it to be a workable and sensible definition.

146. However, if the Commission would prefer to rely on a definition that has been used internationally, we suggest the use of one of the following:

> *An emergency occurs when the GTB reasonably believes there to be a situation which may threaten:*
> *(i) reliability of gas supply; or*
> *(ii) system security or the security of a declared distribution system; or*
> *(iii) public safety.*[33]
>
> *an emergency endangering persons and arising from a loss of pressure in a network or any part thereof*[34]

147. We consider that either of these definitions would also be workable and sensible, although they are narrower than our preferred definition.

148. Vector would welcome the opportunity to discuss this matter further with the Commission.

Definition of emergency for GDBs

149. Vector **supports** the Commission's proposed definition of emergency for GDBs, which is consistent with the definition of emergency used in the Gas Authorisation decision.

Exemptions for circumstances outside of suppliers' control

150. Vector welcomes the Commission's proposal to allow for exemptions from the 180 minute requirement where events occur outside of the suppliers' control. While this proposal adopts Vector's recommendation, on reflection we believe it would be improved by specifying up front either a list of circumstances in which exemptions would be provided or guidelines to describe how the Commission would approach exemption requests. This would improve certainty for suppliers.

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[32] Consultation paper, paragraph 5.12.

[33] Derived from the Australian National Gas Rule 333. In Part 19 Declared Wholesale Gas Market Rules, at the link: http://www.aemc.gov.au/Gas/National-Gas-Rules/Current-Rules.html

[34] From the UK Gas Safety (Management) Regulations 1996, clause 2.

151. If the Commission develops a list of circumstances in which exemptions would be granted, the list should not be exhaustive and exemptions could also be granted in other circumstances subject to Commission agreement. Vector **recommends** the Commission amend clause 9 of the GDB and GTB DPP determinations to state circumstances in which exemptions will normally be granted.

152. Vector **recommends** the Commission define circumstances in which an exemption would be granted from the 180 minute requirement as follows:

    a. an event or circumstance beyond the reasonable control of a GPB and includes, but is not limited to:

        (i) acts of God;

        (ii) fire, landslide, earthquake, lightning, storm, flood, volcanic eruption, tsunami or tempest;

        (iii) strikes, lock-outs or labour disputes of any kind;

        (iv) acts of terrorism, sabotage, acts of war, blockades, insurrections, riots, civil disturbances and epidemics;

        (v) failure of an IT or telephone system;[35] and

        (vi) a requirement of any Authority that precludes or limits performance of obligations.

153. This list is based on relevant force majeure provisions in extant gas contracts, which Vector has reviewed in the preparation of this submission.

[35] This is suggested to cover situations where communications with the response team are impeded by system failure outside of the GPB's control.

REGULATION OF GAS TRANSMISSION BUSINESSES

Introduction

154. The consultation paper discusses certain issues that relate to GTBs only. This section provides Vector's response to those issues.

Comments by Major Gas Users Group

155. We have reviewed the comments by the Major Gas Users Group (MGUG) referenced within the consultation paper.[36]

156. Vector welcomes the Commission's draft decision to reject MGUG's recommendation that a price cap rather than a revenue cap should apply to gas transmission. As recognised by the Commission, demand is more variable on the gas transmission system than on the distribution system. For Vector, this is largely due to the varying demand of power stations.[37] Transmission requests for large new dairy, glasshouse and power generation schemes are regularly considered. If just one of these is realised, annual growth will exceed the Commission's proposed forecasts. However, such occurrences are relatively infrequent and can occur in almost any part of the transmission system. Hence it is very difficult to forecast load growth accurately for gas transmission.[38]

157. MGUG states that a sufficiently robust projection of demand for transmission can be developed based on analysis of historical trends at various gas transmission injection and receipt points, particularly for a two-year period.

158. However, the analysis provided by the draft Concept Report in its Supply and Demand study for the GIC illustrates the difficulties in forecasting demand growth, as does the Commission's own analysis used to determine demand growth in the DPP reset.

159. MGUG is also incorrect to state that gas transmission businesses "should know the main demand drivers at each off-take point". Vector has no contractual relationship with users downstream of the transmission system. Our contractual relationship is with shippers only. Vector has limited visibility of the demand of a few individual consumers, e.g. those that are supplied through a dedicated delivery point (such as power stations). However, these circumstances only apply to a small number of delivery points. In all other cases Vector provides capacity/gas in bulk, without knowing the number, identity or type of customers supplied. It is therefore not possible for Vector to understand the demand drivers of parties that are not contractual customers of Vector.

Trend in transmission revenues

160. In setting a price for the gas transmission businesses, the Commission has made a series of simplifying assumptions. These assumptions and Vector's comments on them are set out in the table below.

[36] Consultation paper, paragraphs E14-E15 and F13.
[37] Contrary to the view expressed in paragraph E12 of the consultation paper, variance in petrochemical demand is mainly an issue for the Maui pipeline as it is Maui that supplies Methanex.
[38] For more information see Vector Limited, *Cross-submission on the Initial DPP for GPBs Draft Reasons Paper*, 20 January 2012.

Table 1: Comments on simplifying assumptions made by the Commission

Commission simplifying assumption	Vector comment
The billed quantities of transmission businesses will not change over the duration of the regulatory period.	There may be some changes in the quantities billed to individual shippers but these are unlikely to make much difference to the total billed quantities. Variations in total billed quantities may change over the regulatory period but, as noted elsewhere in this submission, it is very difficult to forecast demand accurately.
There will be no charges for overrun of capacity on the Vector transmission pipelines.	On balance, Vector considers that this assumption is reasonable as the amount of overruns charged, while never zero, is a small percentage of transmission revenues and it is difficult to forecast the quantity of overrun charges.
Vector's capacity forecast is based on Concept's peak week forecast.	The Commission's approach reflects Vector's view that modelling the "5-day peak" is generally the most appropriate approach to determining a gas transmission pipeline's capacity. The Commission's discussion in paragraph F59 is also correct – demand may increase or decrease, but at the same time may also become less or more peaky (i.e. the load factor may change), which could be a greater driver of shippers' capacity reservations. However, the peak week analysis in the Concept Report extends from the analysis of the peak week in 2011. Concept identified the peak week in 2011 to be a 1 in 95 year event.[39] Hence any projections from this baseline are likely to over-forecast gas transportation volumes
The 8% growth in reserved capacity on the Vector network between 2008 and 2011 is unlikely to continue.	Vector agrees that the growth in reserved capacity observed in recent years is unlikely to continue. It is our view that the high rate of increase the Commission has observed will be more related to shippers adjusting their positions than to any underlying change in demand for capacity. This has most likely occurred due to the expiration of Supplementary Agreements (meaning shippers need to replace the supplementary capacity with reserved capacity, to an extent) and the perceived North Pipeline constraint incentivising shippers to hold capacity on that pipeline and book capacity elsewhere.

[39] Concept Report, pages 108-109.

Process for approving balancing gas amounts

161. The Commission has set out a detailed process for the approval of balancing gas amounts as recoverable costs under the GTB IM. Vector welcomes the Commission's willingness to specify up front how this process will operate.

162. Vector has reviewed the Commission's proposal and believes it is workable, but not optimal. The decision date of 31 May is the same day that provisional prices have to be notified to customers under the Vector Transmission Code. This means the Commission's final decision on recoverable costs would not be taken into account when setting provisional prices. Although this is manageable as we will know what we have asked to be treated as recoverable costs and should be able to predict the Commission's eventual decision approving these costs, it is not ideal. Vector **recommends** the decision date is set at mid-April and information is provided by Vector by the end of February each year.

163. However, Vector notes that the Commission's process would result in a lengthy lag before the balancing gas amounts are recovered. Ongoing, we understand the process would not allow costs to be recovered for some time:

   a. Year 1: Assessment period

   b. Year 2: lodge balancing gas statement, which is then approved by the Commission

   c. Year 3: unallocated balancing costs are recovered.

164. If this lagged approach is adopted, Vector **recommends** the balancing gas recoverable cost includes an allowance for use of money, otherwise the costs will never be fully recovered. Vector submits that the discount rate used for claw-back of under-recovery would be suitable for this purpose.

165. In addition, it is not clear under what circumstances the Commission would approve the balancing gas amount. In regard to similar costs for electricity distribution, the Commission has indicated that all that will be needed for approval is proof of the amount of the recoverable cost.[40] Vector **recommends** the Commission make a similar commitment for approving balancing gas as a recoverable cost. This will improve certainty for businesses regarding cost recovery and, given transmission service providers have no control over the amount of balancing gas costs, there is no need to apply any type of efficiency testing to the balancing gas amounts.

EGCC levies should be pass-through costs for gas transmission

166. The Commission notes in footnote 199 of the consultation paper that EGCC levies are not treated as pass-through costs for GTBs, as provided for in the IMs. While it is correct that the IMs do not specify EGCC levies as pass-through costs, this is because GTBs were not subject to EGCC levies at the time the IMs were determined. However, GTBs became subject to EGCC levies on 1 April 2011. The Commission has previously indicated that it would amend the IMs to provide for the pass-through of EGCC levies.[41]

167. Vector **recommends** the Commission amend the GTB IMs to allow for the pass-through of EGCC levies, before the DPP determination is made.

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[40] Commerce Commission, *2010-15 Default Price-Quality Path Starting Price Adjustments and Other Amendments Update Paper*, April 2011, paragraph 8.9.

[41] Email from Karen Murray to Ian Ferguson of 24 June 2011. Statements by Commission staff at gas DPP model workshop on 7 November 2012.

MATTERS DISCUSSED IN PREVIOUS SUBMISSIONS

Cross-over with consultation and submissions on electricity starting price adjustments

168. The Commission's draft decisions and discussion on a number of issues within the consultation paper largely follow the draft decisions and discussion within the Commission's electricity Revised Draft Reset of the 2010-15 Default Price-Quality Paths, dated 21 August 2012. Our response to these matters was provided in our submission and cross-submission.[42] We do not repeat our views here, but note that the comments are directly applicable to the gas DPP reset. Hence Table 2 below provides a guide referencing the discussion of the relevant issues in our previous submissions and supporting documents.

169. The Commission should consider the comments made in the referenced sections of the previous submissions as being submissions in response to the gas DPP price reset draft decision.

Table 2: Reference to relevant material in submissions on recent EDB price reset draft decision

Issue	Paragraph/ Section reference	Document
Ensuring accurate understanding of the impact of P0 adjustments	39-41	Vector submission on EDB draft reset
Appropriate discount rate to apply to claw-back	144 – 149	Vector submission on EDB draft reset
	28-42	Vector cross-submission on EDB draft reset
		CEG, Application of claw-back, Report to Vector, June 2012
The period of time (number of regulatory years) over which the claw-back occurs	152 - 157	Vector submission on EDB draft reset
Regulatory error and asymmetric risk	158 - 185	Vector submission on EDB draft reset
	5c, 6 - 11	Vector cross-submission on EDB draft reset
	Section 6	Castalia Evidence on the Impacts of Regulatory Incentives to Improve Efficiency, Report to Vector, April 2012.
Incentives to improve efficiency	186 - 212	Vector submission on EDB draft reset
	5d	Vector cross-submission on EDB draft reset
		Castalia Evidence on the Impacts of Regulatory Incentives to Improve Efficiency, Report to Vector, April 2012.
		CEG, Empirical studies on the impacts

[42] Vector Limited, *Submission to the Commerce Commission on Revised Draft Reset of the 2010-15 Default Price-Quality Paths for Electricity Distribution Businesses*, 1 October 2012. Vector Limited, *Cross-submission: Revised Draft Reset for EDB DPPs*, 12 October 2012.

Issue	Paragraph/ Section reference	Document
		of economic regulation, Report to Vector, July 2012
Issues with the WACC adopted in CPPs	226 - 236	Vector submission on EDB draft reset
Cash flow timing assumptions	69-76	Vector submission on EDB draft reset
	Pages 22-24	Castalia Strategic Advisors, *Review of Revised Draft Reset of 2010-15 Default Price Quality Paths: Report for Vector Limited*, September 2012
Term credit spread differential allowance	66-68	Vector submission on EDB draft reset
Permanent and temporary differences	81-83	Vector submission on EDB draft reset
Calculation of depreciation	84-88	Vector submission on EDB draft reset

170. In addition, we have some further comments set out below.

Asymmetric risk and regulatory error:

171. We struggle to understand the Commission's claim that "The fact that we can set a customised price-quality path lower than a default price-quality path does not imply that a customised price-quality is a high risk option for suppliers."[43]

172. The Commission is effectively defining risk narrowly as being the risk that a regulated supplier will earn below normal returns under a CPP, rather than the risk that the regulated supplier will be made worse off under a CPP than a DPP. Vector submits that both forms of risk are valid risks that a rational regulated supplier would take into account when deciding whether to apply for a CPP.

173. The Commission goes on to argue that "For example, it would be appropriate for a customised price-quality path to be lower than a default price-quality path if the supplier would otherwise expect to over-recover its costs. Section 53V simply provides protection against the risk that customised price-quality path proposals are seen as a 'one way' bet by suppliers, which would result in a significant number of proposals for us to consider each year".[44]

174. All the Commission has done is summarised the policy reasons why the Government decided to enable the Commission to set CPPs lower than DPPs. Whether or not there is a sound policy justification is irrelevant to the question of whether there is a risk or high risk that the regulated supplier could be worse off under a CPP than a DPP. Based on the IMs and decisions the Commission has made, Vector believes there is a very real risk that a regulated supplier that is

[43] Consultation paper, footnote 93.
[44] ibid.

unable to earn a commercially-realistic return or needs a CPP to enable a major capital investment[45] could be made worse off by the Commission's CPP decision.

175. The risk of regulatory error, and the adverse potential consequences, will be greater the higher the level of starting price adjustment. Vector accordingly considers that asymmetric risk is an even larger risk in relation to the Commission's draft reset decisions in relation to our gas businesses, compared to for our electricity distribution business (EDBs).

176. Finally, we note in paragraph 6.4 that the Commission appears to consider the use of the 75th percentile WACC is sufficient to address the risk of forecast error. Vector strongly disagrees and submits that the Commission is mischaracterising the nature of the 75th percentile WACC estimate, which is to address WACC estimation error and not forecasting error.[46] Vector re-emphasises that it understands the 75th percentile WACC to be the best estimate of true WACC to use, given the asymmetry of risk from under-investment and in the context where there is an unacceptably high (50%) chance the mid-point WACC estimate is below the true WACC.

Efficiency incentives/IRIS

177. Vector is pleased to see that Contact Energy and MEUG support the adoption of an IRIS for DPPs. It is notable that these were the only non-EDBs to submit on the Commission's Revised Draft Reset of the 2010-15 Default Price-Quality Paths for EDBs.

Claw-back

178. Vector agrees with the Commission that claw-back, if applied, should be applied over-time to minimise undue financial hardship.[47] Where claw-back is substantial and/or applied as a mid-period reset it may be appropriate or necessary to apply it over more than one regulatory period.

Discount rate for claw-back

179. The Commission is now considering whether to use the time value of money reflecting the interest rates consumers face (for investment and for borrowing). Vector agrees this is a valid option. The Commission should recognise that any recovery of alleged over-charging effectively amounts to a tax-free return for consumers. The discount rate adopted should reflect this "tax advantage".[48]

180. The Commission's electricity final price reset decision for the 2010-15 Default Price-Quality Paths, dated 30 November 2012, applied a discount rate for claw-back that was equal to the pre-tax cost of debt.[49] The consultation paper seems to propose using the 75th percentile estimate for claw-back for GasNet.[50] Vector

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[45] Particularly as s 54S and R are limited to Transpower only. This means a regulated supplier seeking approval of an investment would face scrutiny not only of the investment, but of its entire business. The Commission could readily mitigate the risks and costs specific to applying for a CPP, where it is needed for a specific investment, by allowing regulated suppliers to apply for limited-form CPPs which are limited to considering whether an additional allowance (to the DPP) should be provided specific to the proposed investment, without reviewing the regulated supplier's entire business.

[46] See, for example, Vector Limited, *Submission to Commerce Commission on 2010-15 DPP Starting Price Adjustment and Other Amendments Update Paper*, 16 May 2011, paragraphs 111-118.

[47] Consultation paper, paragraph L58. The Commission only made reference to applying claw-back over-time in its electricity Revised Draft Reset of the 2010-15 Default Price-Quality Paths where claw-back would be for in excess of CPI+15% (paragraph 145 of that consultation paper).

[48] Vector, *Submission to the Commerce Commission on Revised Draft Reset of the 2010-15 Default Price-Quality Paths for Electricity Distribution Businesses*, 1 October 2012, paragraph 148b.

[49] Commerce Commission, *Resetting the 2010-15 Default Price-Quality Paths for 16 Electricity Distributors*, 30 November 2012, paragraph J26.

[50] Consultation paper, paragraph L60.

considers that the Commission's decision in the final EDB price reset decision was preferable and **recommends** the Commission set the discount rate for claw-back equal to the pre-tax cost of debt for GPBs.

Term credit spread differential allowance

181. The Revised Gas Draft Decision Financial Model allocates term credit spread differential allowances of $88,000 to Vector distribution and $100,000 to Vector transmission. The Commission's approach to calculating the term credit spread differential allowance remains opaque and Vector's own analysis does not deliver the outcomes the Commission has produced. Vector **invites** the Commission to engage with Vector on this matter to ensure the allowances are calculated accurately. Vector also **recommends** the Commission produce its working to demonstrate how the allowances were calculated.

Calculation of depreciation

182. Vector refers the Commission to the further discussion of this matter in the CEG report and **supports** CEG's recommendation.[51]

[51] CEG, *Default price-quality path reset for gas pipelines*, November 2012, section 5.2.

COMMENTS ON DRAFTING OF THE DETERMINATIONS

183. This section provides comments on the drafting of the DPP determinations for GTBs and GDBs.

184. Schedule 7, Table 5: the end date of the first assessment period applying to Vector should be 30 September 2014.

185. The restructure clauses in 8.6 of the GTB and GDB DPP determinations are incorrect:

    a. They appear to have been copied from the EDB DPP determination, but this is incorrect for gas transmission as, under a revenue cap, it should not refer to price restructuring and allowable notional revenue because the allowable notional revenue does not depend on prices.

    b. Further, the clauses (and the equivalent EDB clauses) should refer to notional revenue, not allowable notional revenue. Allowable notional revenue is a fixed number for a year so cannot change if prices change. Vector has previously pointed this out in the context of our EDB price compliance statements and in our recent submission on the implementation paper for the EDB price reset.[52]

    c. The clause is problematic anyway as it is not feasible to determine what the tariffs would have been if the restructure had not occurred.

186. The auditor’s report in Schedule 9 refers to “the assessment period ended on [*insert assessment date*]”. This does not work as the assessment dates are not defined as the end date of the assessment period.

187. Clause 11.2.6(b) of the GTB determination contains a typo – should refer to “that clause”, not “that clauses”.

188. Clause 11.2.10(c) of the GTB determination – there should be a comma between “nature” and “cause”.

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[52] Vector Limited, *Implementation of the Proposed Reset of the 2010-15 Default Price-Quality Path*, 26 November 2012, pages 3-4.