



**Submission to the Commerce Commission on
Initial DPP for GPBs Draft Reasons Paper**

19 December 2011

TABLE OF CONTENTS

EXECUTIVE SUMMARY	3
Service quality standards	3
Price and regulatory period under the initial DPP	4
Section 54F(4) reset and claw-back	5
INTRODUCTION	7
AREAS OF AGREEMENT	8
Emergency Response Times	9
CPI ADJUSTMENTS FOR UNCONTROLLED GPBS	11
Statutory framework	11
Relevant legal principles	12
Analysis	13
SECTION 55F(4) RESET	18
Stylised example	19
Appropriate approach to efficiency incentives	22
CLAW-BACK (s 55F(4))	23
CONCLUDING REMARKS AND RECOMMENDATIONS	25
Service quality standards	25
CPI adjustments for uncontrolled GPBs	25
Section 54F(4) reset and claw-back	26
Recommendations	26

EXECUTIVE SUMMARY

1. There are a wide range of matters covered in the Draft Reasons Paper where Vector is in agreement with the Commerce Commission (Commission); particularly in relation to service quality standards, and transitional arrangements.
2. The key aspects of the Commission's proposals Vector believes could be improved include:
 - a. **Emergency response times:** Inclusion of a force majeure clause in the service quality standards to recognise there may be circumstances outside of a gas pipeline business's (GPB's) reasonable control which may mean it is not always possible to get to an incident within 180 minutes.
 - b. **CPI adjustments for uncontrolled GPBs:** Resetting non-regulated GPBs' prices at July 2012 levels not July 2010 levels.
 - c. **Section 55F(4) reset and claw-back:** Ensuring decisions on whether or not to proceed with a section 55F(4) resets and/or claw-back, and on the design of the Starting Price Adjustment (SPA) Input Methodology (IM) (including application of a staggered SPA) and an Incremental Rolling Incentive Scheme (IRIS), are made in a holistic manner, which fully recognises that the share of efficiency gains regulated suppliers receive will affect their incentives to improve efficiency.

Service quality standards

3. Vector considers that the Commission's approach to service quality level setting is sensible; and reflects a logical and reasonable development of the Commission's proposals and adaption of Vector's previous recommendations.
4. For the avoidance of doubt, Vector agrees with the Commission on the following matters:
 - a. The Commission should avoid "duplicating existing mechanisms that monitor and enforce safety and quality of gas pipelines."¹
 - b. Vector supports the Commission's definition of an emergency as an incident for which one of the emergency services (police, fire service, etc) is called.
 - c. Vector supports adoption of Emergency Response Time (ERT) as the sole service quality measure for the initial regulatory period.
 - d. Quality standards should be set as an ERT of 80% in no more than 60 minutes for GDBs only and, subject to the qualifications provided below, 100% in no more than 180 minutes (for GDBs and GTBs).
 - e. The Commission should not require regional disaggregation and reporting of quality standards.
5. Vector considers, however, that the 180 minutes/100% cap should be amended to allow for force majeure type circumstances where it may not be

¹ Paragraph x.5, Commerce Commission, Draft Reasons Paper, *Initial Default Price-Quality Paths for Gas Pipeline Businesses*, 21 November 2011.

reasonable or practicable for a GPB to respond within 180 minutes. For example, "acts of God" such as earthquakes, floods and volcanic eruptions which damage gas pipelines could also damage access roads and prevent or make access difficult.

6. The Commission could address this issue by retaining the 100% cap, but allowing itself discretion to provide exemptions where the Commission is satisfied there are circumstances outside of the GPB's reasonable control which means imposing the 180 minutes cap would not be practicable or reasonable. GPBs would not know whether or not any particular breach of the 180 minute rule would meet this test. As a consequence, their incentives to make best endeavours to meet the 180 minute cap would not be diluted by such a provision.

Price and regulatory period under the initial DPP

7. Vector generally considers that the Commission has dealt with transition issues pragmatically, and agrees with the Commission on the following matters:
 - a. Claw-back under s 55F(2) of the Commerce Act 1986 is not required for Vector.
 - b. The Commission should adopt an initial 15 month assessment period to align the regulatory period to a 1 October financial year.
 - c. It is acceptable, as a "pragmatic approach", to have a 24 hour regulatory overlap between Gas Authorisations and the Initial DPPs.
 - d. It is appropriate to provide GPBs the option of resetting their prices on 1 July 2012 or 1 October 2012,² but with changes "to compensate users of gas pipeline services for any over-charging in the price path for the first three months of the Initial DPP."³
 - e. The Commission is correct that it is not "able to set Initial DPPs from an earlier date, for example 1 July 2010. Section 53M(7) prevents us from setting a DPP that applies retrospectively."⁴
8. Where Vector does not agree with the Commission is in relation to the reset of prices for non-regulated GPBs.
9. Vector submits the Commission has erred in its legal interpretation that it is required to reset non-regulated GPBs prices to July 2010 levels rather than July 2012 levels. In particular:
 - a. The Commission has adopted an interpretation that is inconsistent with the plain meaning of sections 53P and 55F, considered in light of the statutory scheme and purpose.

² Paragraph 7.18 of the Commerce Commission's Draft Reasons Paper "Initial Default Price-Quality Paths for Gas Pipeline Businesses", 21 November 2011 states that the date is 2013. Vector notes, however, that paragraph 32 of the Commerce Commission's subsequent Process and Issues Paper, "Additional Input Methodologies for Default Price-Quality Paths", 9 December 2011, states that "the earliest that a price adjustment for gas pipeline services could take effect is at the start of the 2012 pricing year."

³ Paragraph 7.18 of the Commerce Commission's Draft Reasons Paper "Initial Default Price-Quality Paths for Gas Pipeline Businesses", 21 November 2011.

⁴ Paragraph 7.39 of the Commerce Commission's Draft Reasons Paper "Initial Default Price-Quality Paths for Gas Pipeline Businesses", 21 November 2011.

- b. Even if the meaning in the relevant provisions is considered to be unclear, which Vector does not agree is the case, the Commission's position results in absurd and/or anomalous outcomes that could not have been intended by Parliament. (The relevant statutory provisions should and can be read to avoid such anomalous outcomes.)
10. In Vector's submission, the correct interpretation, applying well established principles of statutory interpretation, allows for 2010 to 2012 CPI adjustments to be included in starting prices for uncontrolled GPBs in the initial DPP.
11. If the Commission does not agree, or is uncertain about Vector's legal interpretation, we believe the Commission should urgently refer the question to the Court under section 100A of the Commerce Act for a final view.
12. An alternative approach would simply be not to undertake a regulatory price reset under section 53P(B) until the beginning of the next regulatory period. Prices would continue to be capped at inflation under the first DPP (where the Commission is rolling over prices and proposing $X=0$). This would also avoid the problems that arise with undertaking mid-regulatory period resets.

Section 54F(4) reset and claw-back

13. The Commission intends to "roll over" existing prices for the initial DPP under section 53P(3)(a). The Commission has also commenced a separate process for determining SPA IMs for EDBs and GPBs.
14. Under section 55F(4), once an SPA IM is determined, the Commission may reset the GPB DPP if the SPA IM would have resulted in a materially different price path.
15. As set out in its recent Process and Issues Paper⁵, the Commission intends to consult on whether or not to reset GPB DPPs under section 55F(4) "post 2012".⁶ While Vector will be making further submissions on this question, Vector sets out in this submission some initial concerns regarding any such reset.
16. Vector has previously submitted the Commission should not reset GPB prices based on current and projected profitability until the beginning of the next regulatory period because of the poor quality information currently available for GPBs. This remains Vector's position. In this submission, Vector raises additional concerns in relation to a section 55F(4) reset. These are based on the Commission's SPA methodology as set out in previous SPA consultation (proposed SPA methodology).
17. Under the Commission's proposed SPA methodology, a section 55F(4) reset and claw-back would exacerbate the already inadequate incentives for suppliers to improve efficiency.
18. In particular, under the Commission's proposed SPA methodology all current and projected supranormal profits are removed from prices at the start of each regulatory period. As set out in its previous submissions, Vector does

⁵ Commerce Commission, *Additional Input Methodologies for Default Price-Quality Paths: Process and Issues Paper*, 9 December 2011,

⁶ Commerce Commission, *Additional Input Methodologies for Default Price-Quality Paths: Process and Issues Paper*, 9 December 2011, para 32 and table 3.

not believe this approach provides adequate incentives for regulated suppliers to improve efficiency, as required by s 52A(1)(b) of the Commerce Act, given:

- a. Such an approach would provide regulated suppliers with a maximum of 5 years to benefit from any efficiency gains.
 - b. In the best case scenario for regulated suppliers where the efficiency gain is made on day one of the regulatory period, and there is no cost to making the efficiency gain, the benefit to the regulated supplier of making a permanent cost saving would be 36.1% of the efficiency gain.⁷ Critically, this plummets to a mere 6.2% in the final year of the regulatory period.
19. The Commission may be concerned that delays in resetting prices may mean some regulated suppliers benefit from higher prices than they would otherwise have faced. Such factors, however, need to be weighed against the Commission's statutory purpose, and the fact that a mid-period price reset based on the Commission's proposed SPA methodology, coupled with claw-back, would have a chilling effect on incentives to improve efficiency over the entirety of the first regulatory period.
 20. The share of any efficiency gain a regulated supplier would make between July 2012 and July 2013 would be a maximum of 6.2% dwindling further to zero the closer to July 2013 the efficiency gain is made. For the period between July 2013 and October 2016, the maximum share of any efficiency gain the regulated supplier would earn would be capped at 23.1%. The share would be smaller still or negative if there was any cost incurred to achieve the efficiency gain.
 21. It is not clear to Vector what incentives this would provide regulated suppliers to improve efficiency in the first regulatory period.
 22. These problems would not be so acute if the Commission adopted a staggered SPA and/or IRIS (as Vector has recommended in previous submissions). However, should the Commission maintain its current approach to efficiency gains in the SPA IM, it could be more profitable for regulated suppliers to delay making the efficiency enhancements until immediately after October 2016, if at all.
 23. The Commission should consider: (i) the impact of a section 55F(4) reset on incentives to improve efficiency (in the context of the SPA IM adopted); and (ii) whether the Commission should delay any price reset to the beginning of the subsequent regulatory period rather than undertake a mid-period (having regard to (i)).

⁷ This assumes the WACC is 8%. The share would be higher the higher the WACC is and vice versa. For example, the regulated supplier's share of the efficiency gain would be 40.7% of the WACC is 10% and 31.4% of the WACC is 6%. The closer the efficiency share (otherwise known as incentive power) is to zero the closer the operation of price control resembles rate of return regulation.

INTRODUCTION

24. Vector welcomes the opportunity to submit on the Commerce Commission's (Commission) Draft Reasons Paper "Initial Default Price-Quality Paths for Gas Pipeline Businesses", 21 November 2011. No part of Vector's submission is confidential and we are happy for it to be publicly released.
25. Vector acknowledges and appreciates the Commission providing a prompt response to our request for an explanation of the Commission's conclusion that it is required to reset prices for non-regulated Gas Pipeline Businesses (GPBs) at July 2010 levels. The explanation the Commission has provided has enabled Vector to respond in a constructive and meaningful way, including providing the Commission with an alternative legal basis on which it could rely to reset prices at July 2012 levels.
26. If the Commission has any queries regarding Vector's submission, or would like further information, please contact:

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AREAS OF AGREEMENT

27. There are a wide range of matters covered in the Draft Reasons Paper where Vector is in agreement with the Commission. For the avoidance of doubt, Vector agrees with the Commission on the following matters:

Service quality

- a. The Commission should avoid “duplicating existing mechanisms that monitor and enforce safety and quality of gas pipelines.”⁸
- b. Vector supports the Commission’s definition of an emergency as an incident for which one of the emergency services (police, fire service, etc) is called.
- c. Vector supports adoption of Emergency Response Time (ERT) as the sole service quality measure for the initial regulatory period..
- d. Quality standards should be set as an ERT of 80% in no more than 60 minutes for GDBs only and, subject to the qualifications provided below, 100% in no more than 180 minutes (for GDBs and GTBs).
- e. The Commission should not require regional disaggregation and reporting of quality standards.

Price and regulatory period under the initial DPP

- f. Claw-back under s 55F(2) of the Commerce Act 1986⁹ is not required for Vector.
- g. The Commission should adopt an initial 15 month assessment period to align the regulatory period to a 1 October financial year.
- h. It is acceptable, as a “pragmatic approach”, to have a 24 hour regulatory overlap between Gas Authorisations and the Initial DPPs.
- i. It is appropriate to provide GPBs the option of resetting their prices on 1 July 2012 or 1 October 2012,¹⁰ but with changes “to compensate users of gas pipeline services for any over-charging in the price path for the first three months of the Initial DPP.”¹¹
- j. The Commission is correct that it is not “able to set Initial DPPs from an earlier date, for example 1 July 2010. Section 53M(7) prevents us from setting a DPP that applies retrospectively.”¹²

Section 53M(7) states that no DPP applies to a regulated supplier until the date specified in the relevant 52P determination, which must be a

⁸ Paragraph x.5 of the Commerce Commission’s Draft Reasons Paper “Initial Default Price-Quality Paths for Gas Pipeline Businesses”, 21 November 2011.

⁹ Unless otherwise stated in this submission, a reference to a section of an Act is a reference to a section of the Commerce Act.

¹⁰ Paragraph 7.18 of the Commerce Commission’s Draft Reasons Paper “Initial Default Price-Quality Paths for Gas Pipeline Businesses”, 21 November 2011 states that the date is 2012. Vector notes, however, that paragraph 32 of the Commerce Commission’s subsequent Process and Issues Paper, “Additional Input Methodologies for Default Price-Quality Paths”, 9 December 2011, states that “the earliest that a price adjustment for gas pipeline services could take effect is at the start of the 2013 pricing year.”

¹¹ Paragraph 7.18 of the Commerce Commission’s Draft Reasons Paper “Initial Default Price-Quality Paths for Gas Pipeline Businesses”, 21 November 2011.

¹² Paragraph 7.39 of the Commerce Commission’s Draft Reasons Paper “Initial Default Price-Quality Paths for Gas Pipeline Businesses”, 21 November 2011.

date at least 4 months after the determination is published. This precludes retrospective determination of a DPP.

In circumstances where a DPP has not been set by the end of the regulatory period, section 53P(11) provides that existing starting prices, rates of change and quality standards continue to apply until the DPP is set. This is consistent with section 53M(7), as it specifically avoids the need for determination of a retrospective DPP.

Form of control and rates of change

- k. A weighted average price cap should apply to suppliers of gas distribution services and a total revenue cap should apply to suppliers of gas transmission services.
- l. The X factor should have no productivity adjustment. Energy Insights' review provides a reasonable basis for reaching this conclusion.

Other matters

- m. The Commission should "have regard to submissions received in relation to the draft GDB determination in considering the draft GTB determination and vice versa."¹³
- n. Gas distribution and transmission should be treated as separate services for regulation.
- o. It is appropriate to allow Vector the discretion to determine the boundary between the "delivery point" and "receipt point" for Vector's GDB and GTB, subject to a requirement this "does not result in the duplication of assets as being both transmission and distribution assets."¹⁴

Emergency Response Times

- 28. As noted above, Vector supports the adoption of ERT as the sole service quality measure for gas pipeline services.
- 29. There has been quite a lot of evolution in the development of service quality measures. The Commission has adapted Vector's recommendations by: (i) adopting a single ERT service quality measure for the initial DPP; and (ii) applying a standard of 80% of GDB emergency responses being within 60 minutes.
- 30. The adaption of this proposal to include a cap of 180 minutes for GTBs and GDBs is sensible. Without this, there would be no regulatory compliance incentive for a GDB to manage performance beyond 60 minutes.
- 31. However, exceptional circumstances may arise where it is not reasonable or practicable to comply with a 180 minute time limit. For example, "acts of God" such as earthquakes, floods and volcanic eruptions which damage gas pipelines could also damage access roads and prevent or make access difficult. The extended closure of SH3, since October, through the Manawatu Gorge due to a slip highlights the impact natural disasters can have on the time it would take to get to an incident.

¹³ Paragraph 1.6 of the Commerce Commission's Draft Reasons Paper "Initial Default Price-Quality Paths for Gas Pipeline Businesses", 21 November 2011.

¹⁴ Paragraph 3.12 of the Commerce Commission's Draft Reasons Paper "Initial Default Price-Quality Paths for Gas Pipeline Businesses", 21 November 2011.

32. Vector **recommends** the Commission adopt an exception clause to the ERT along the lines that “The Commission may grant an exemption to the 180 minute service quality cap for gas pipeline businesses if: (i) there are circumstances outside the GPB’s reasonable control which the Commission is satisfied means imposing the 180 minutes cap would not be practicable or reasonable; and (ii) the extent of the breach of the 180 minutes cap was reasonable under the circumstances”.
33. This would not adversely impact on GPBs’ incentives to make best endeavours to meet the 180 minute time limit as they would not know, until after the event, whether or not the Commission would deem that the breach meet the conditions of the exception clause. Further, the current 180 minute test does not distinguish between a breach by one minute or 180 minutes. The qualification that the extent of the breach must be reasonable under the circumstances means GPBs would be incentivised not only to operate within the 180 minute cap, but also to minimise the duration of any breach.

CPI ADJUSTMENTS FOR UNCONTROLLED GPBS

34. The Commission states that the starting prices in the first DPP for uncontrolled GPBs¹⁵ will not include movement in the CPI after 30 June 2010.¹⁶ While, the Commission acknowledges the result is "unfortunate",¹⁷ it states that, in its view, it is one required by the Commerce Act.
35. Vector submits the Commission has erred in its interpretation of the relevant statutory provisions. In particular, the Commission has adopted an interpretation that is inconsistent with the plain meaning of the text, considered in light of the statutory scheme and purpose. Even if the meaning in the relevant provisions is considered to be unclear, which Vector does not agree is the case, the Commission's position results in absurd and/or anomalous outcomes that could not have been intended by Parliament. The relevant statutory provisions should and can be read to avoid such anomalous outcomes.
36. In Vector's submission, the correct interpretation, applying well established principles of statutory interpretation, allows for 2010 to 2012 CPI adjustments to be included in starting prices for uncontrolled GPBs in the initial DPP.

Statutory framework

37. Under section 55E(2) the Commission must set the first DPP determination for GPBs as soon as practicable after 1 July 2010. Section 55F(1) then provides that the first DPP must be set using the processes set out in section 53P.
38. Section 53P sets out the process for amending an existing DPP determination by setting the starting prices, rates of change and quality standards for the following regulatory period. Of significance, section 53P(11) provides that if a DPP is not set by way of amendment of the section 52P determination by the end of a regulatory period, starting prices, rates of change and quality standards that applied at the end of the regulatory period continue to apply.
39. Because the proposed DPP will be the first DPP to be set for GPBs, section 55F(1) deems that section 53P applies to uncontrolled GPBs as if 30 June 2010 was the end of the previous regulatory period under the Commerce Act. This "deeming" enables section 53P to be applied to uncontrolled GPBs¹⁸ such that:
 - a. If the Commission rolls over prices under section 53P(3)(a), the starting prices are the prices that were charged by Vector's uncontrolled GPBs as at 30 June 2010 (subject to section 53P(11)).
 - b. If the Commission does not set the DPP by 30 June 2010, as is the case here, section 53P(11) applies. As noted, section 53P(11) provides that the starting prices, rates of change and quality standards that

¹⁵ Where the Commission is intending to roll over existing prices under section 53P(3)(a) of the Act.

¹⁶ Paragraph 7.15 of the Commerce Commission's Draft Reasons Paper "Initial Default Price-Quality Paths for Gas Pipeline Businesses", 21 November 2011.

¹⁷ Paragraph 7.16 of the Commerce Commission's Draft Reasons Paper "Initial Default Price-Quality Paths for Gas Pipeline Businesses", 21 November 2011.

¹⁸ Controlled GPBs are subject to the 2005 Control Order until its expiry on 30 June 2012. The expiry is then treated as if it were the expiry of a customised price-quality path (section 55H). Accordingly, the Commission is not required to apply section 53P process to controlled GPBs when the 2005 Control Order expires.

apply as at 30 June 2010 continue to apply until the Commission determines the DPP.

40. Importantly, under section 55F(2), uncontrolled GPBs are able to increase prices by CPI from 1 January 2008 until the first DPP determination is made. (Under this section the Commission may apply claw-back if, and only if, prices are increased by more than CPI during this period.) That is, the Commerce Act anticipates suppliers legitimately increasing prices by CPI adjustments post-June 2010 in the event that a DPP has not yet been set.
41. The issue is whether, under section 53P(11), prices and rates of changes relative to CPI actually applied by uncontrolled GPBs at the end of the deemed regulatory period continue to apply from June 2010 until the date of the first DPP determination. Section 53P(11) provides:

If starting prices, rates of change, and quality standards have not been set by way of an amendment to the relevant section 52P determination by the end of the regulatory period to which it applies, the starting prices, rates of change, and quality standards that apply at the end of the regulatory period continue to apply until the reset starting prices, rates of change, and quality standards are set.

42. The Commission has concluded section 53P(11) cannot apply to uncontrolled GPBs because there are no starting prices, rates of change or quality standards determined in a section 52P determination that applied at the end of the regulatory period.
43. For the reasons set out below, Vector considers this interpretation is contrary to the plain wording of the section, considered in light of the immediate and general legislative context.

Relevant legal principles

44. In the recent case of *Transpower v Commerce Commission*,¹⁹ Clifford J summarised the principles applied by the Court when interpreting statutes as follows:

- (a) The starting point is s 5(1) of the Interpretation Act 1999:

The meaning of an enactment must be ascertained from its text and in the light of its purpose.

- (b) The relationship between text and purpose, and the significance of what may appear to be plain meaning, were commented on by Tipping J in *Fonterra*:²⁰

- (i) Even an apparently plain meaning is to be cross-checked against purpose:²¹

It is necessary to bear in mind that s 5 of the Interpretation Act 1999 makes text and purpose the key drivers of statutory interpretation. The meaning of an enactment must be ascertained from its text and in the light of its purpose. Even if the meaning of the text may appear plain in isolation of purpose, that meaning should always be cross-checked against purpose in order to observe the dual requirements of s 5. In determining purpose the Court must obviously have regard to both the immediate and the general legislative context. Of relevance too may be the social, commercial or other objective of the enactment.

- (ii) The concept of a plain and ordinary meaning does not involve the Court having regard to external sources such as expert meaning and textbooks – but reference to recognised dictionaries is of course appropriate.²²

¹⁹ *Transpower New Zealand Limited v Commerce Commission* (High Court, Wellington, 4 November 2011, CIV-2011-485-1032), at [17].

²⁰ *Commerce Commission v Fonterra Co-operative Group Ltd* [2007] 3 NZLR 767 (SC).

²¹ At [22].

²² At [23].

(iii) Where meaning is not plain the Court will regard context and purpose as essential guide.²³

(c) As Cooke P observed in *Northland Milk Vendors*,²⁴ the Courts will also try to make enactments work by filling gaps in a statutory scheme in a manner consistent with statutory purpose, and in doing so will have to have regard to legislative statements of purpose. But the Courts must not usurp Parliament's policy-making function. The Courts must therefore be satisfied as to Parliament's intention before acting in that way.

(d) The situations where the apparent meaning of plain and unambiguous language, or strict grammatical meaning, will yield to a meaning to be found in purpose and context (as is argued for here by the Commission) can be categorised either as the application of the general, s 5(1) principle, or of a more particular rule for correcting obvious drafting errors.

45. Where words are unclear or are reasonably capable of more than one meaning, Courts prefer the interpretation that does not lead to injustice or absurdity. The Courts have given the concept of absurdity a wide meaning and seek to avoid any result that is unworkable, anomalous or illogical. This may require a "fair, large and liberal construction" rather than a narrow or technical reading of the words.²⁵
46. Even where words are unambiguous the Courts may be willing to adopt a meaning consistent with the purpose and context albeit on the basis that it must have been a drafting error. That is, if the matter had been drawn to Parliament's attention, Parliament would have amended the relevant provision in the manner contended for.²⁶
47. The Commission argued in *Transpower v Commerce Commission* that meaning should yield to purpose and context because of anomalous consequences. Here, where the Commission acknowledges the consequences are anomalous, the Commission does not appear to have applied the relevant principles of statutory interpretation.

Analysis

48. The scheme of the Commerce Act contemplates section 53P (including section 53P(11)) applying in two scenarios: (a) where there is a section 52P determination in existence; and (b) on a one-off basis, for the first GPB DPPs.²⁷ As referred to above, the statutory scheme also contemplates uncontrolled GPBs increasing prices by CPI until the date of the first DPP determination (section 55F(2)).
49. Contrary to the statutory scheme, the Commission's interpretation restricts the application of section 53P(11) to the first scenario above only.
50. The Commission's interpretation, rather than being the only available product of unambiguous drafting, requires the import of additional words. Specifically, it requires a reading of section 53P(11) as follows:

²³ At [24].

²⁴ *Northland Milk Vendors Association Inc v Northern Milk Ltd* [1988] 1 NZLR 530, at 537.

²⁵ See *Carroll v Attorney General* [1933] NZLR 1461 (CA), where Ostler J stated the Court would "...give the statute...such fair, large, and liberal interpretation as best obtains its objects".

²⁶ In *Transpower v Commerce Commission*, the language in the relevant section (section 91(1B) of the Act) was considered to be obvious or unambiguous. The Commission argued that the ambiguous wording must yield to an interpretation to be derived from purpose and context. Clifford J did not agree on the basis: (a) the obvious meaning was not clearly contrary to the underlying intent; and (b) the "anomalous results" raised by the Commission were not reasons to interpret s 91(1B) in the manner argued for (these results would also arise in the case of judicial review).

²⁷ Note that for EDBs, the thresholds set under the repealed Part 4A of the Act were deemed by the Act to be the first DPP for EDBs (section 54J). The 2010 EDB reset was then determined by the end of the previous regulatory period so section 53P(11) did not apply.

If starting prices, rates of change, and quality standards have not been set by way of an amendment to the relevant section 52P determination by the end of the regulatory period to which it applies, the starting prices, rates of change, and quality standards that apply at the end of the regulatory period, continue to apply until the reset starting prices, rates of change, and quality standards are set **but if and only if there is an existing section 52P determination**.

51. Importantly, the plain meaning of the words does not require the interpretation the Commission adopts. In particular:
- a. "Rates of change" is not expressly defined in the Commerce Act. Under section 53O(b), a DPP determination must include "the rate or rates of change in prices relative to CPI allowed during the first regulatory period". Accordingly the meaning of the phrase "rates of change" is simply a reference to the rate or rates of change in prices relative to CPI. It is not defined by reference to a section 52P determination.
 - b. In relation to "starting prices":
 - i. "Prices" are defined in section 52C of the Commerce Act as meaning one or more of individual *prices*, aggregate prices, or revenues whether in the form of specific numbers or in the form of formulas by which specific numbers are derived.
 - ii. The phrase "starting prices" is not further defined. Under section 53O(a) the Commission must set "starting prices" that apply to the supply of goods or services *during* the first regulatory period.²⁸ This must then be reset in accordance with section 53P(3). Starting prices are, therefore, simply the prices that apply during a regulatory period.
 - c. Quality standards are not defined. While they must be included in a section 53P determination, they are not defined by reference to a section 53P determination.
52. Clearly, where there is an existing DPP determination, prices and rates of change set under that determination are the starting prices and rates of change referred to in section 53P. For uncontrolled GPBs, however, the starting prices and rates of change in the previous regulatory period can only be those prices and rates of change relative to CPI applied by the GPBs; there is no other available meaning in this context.
53. Further and importantly:
- a. section 53P(11) refers to "regulatory period" rather than "section 52P determination" and there is a deemed regulatory period for uncontrolled GPBs; and
 - b. the reference in section 53P(11) to setting starting prices, rates of change and quality standards "by way of an amendment to the relevant section 52P determination" must be read in context where section 53P is deemed to apply to GPBs. That is, the setting of the initial DPP determination is the deemed resetting or amendment of a section 52P determination.

²⁸ While the input methodology determinations define prices in the form of specific numbers, these input methodologies do not apply to the prices set by non-authorized GPBs as at June 2010.

54. Given the above, applying the ordinary meaning of the words and considering these words in the statutory context, for uncontrolled GPBs:
- a. "Starting prices", "rates of change" and "quality standards" in section 53P(11) mean the prices, rates of change and quality standards actually applied by the uncontrolled GPBs at the end of the deemed regulatory period *notwithstanding* that these prices and rates of change were not set out in a section 52P determination.
 - b. CPI adjustments continue to apply either because; they are implicitly linked to the rate of change (which is simply the rate of change relative to CPI - and for Vector's uncontrolled GPBs this was 0); *or* as part of the starting price formula (where for Vector's uncontrolled GPBs the starting price formula applied was (existing) prices plus CPI).
55. To further assist the Commission understand Vector's interpretation, we set below Vector's interpretation of section 53P(11) in the context of uncontrolled GPBs (Interpretation A). The Commission's interpretation is set out as Interpretation B.

	Interpretation A (Plain meaning given text and context)	Interpretation B (Commission's interpretation)
Rates of change	Refers to the rate of change relative to price applied by the relevant supplier as at 30 June 2010 notwithstanding this was not in a DPP determination. Here the rate of change in prices relative to CPI applied by Vector as at 30 June 2010 was 0 (consistent with section 55F).	Refers only to "rates of change" or an X-factor specified in an existing section 53P determination.
Starting prices	Refers to the starting prices actually applied by the uncontrolled GPBs as at 30 June 2010 (which can be expressed either as numbers or as a formula). For Vector the starting price formula applied was (existing) prices plus CPI.	Refers only to starting prices set under a section 52P determination. Because there is no section 52P determination, 53P(11) has no application in relation starting prices for uncontrolled GPBs; and/or "Starting price" must be a number rather than a formula that includes CPI increases.
Quality standards	Refers to any quality standards applied by the uncontrolled GPB.	Refers only to quality standards applied under a DPP determination.

56. Even if the meaning of section 53P(11) was considered to be unclear, which Vector does not agree is the case for the reasons set out above, interpretation A is required in order to avoid an absurd and perverse

outcome. It is commonsense in this situation that Parliament would never have intended CPI adjustments be excluded from the starting prices for the initial DPPs where there was a delay in setting the first DPP. In particular:

- a. Section 53P(11) is intended to preserve the existing position should there be a delay in the setting of a DPP determination. This is intended to ensure suppliers and consumers are not advantaged or disadvantaged in any way by reason of a delay.
 - b. It is perverse to exclude CPI adjustments from the starting prices for the initial DPP determination when those adjustments have been legitimately included in prices by charged by the uncontrolled GPBs in reliance on section 55F(2).
 - c. Starting prices for controlled GPBs will be inclusive of CPI adjustments, and there is no principled basis for such different treatment between controlled and uncontrolled GPBs.
 - d. An arbitrary downward step change in prices is contrary to regulatory certainty and incentives to invest, which are key principles underlying the Commerce Act. At the same time, the step change does not promote other aspects of the section 52A purpose statement (such as limiting excess profits or improving efficiency). Accordingly, the overall impact in relation to the purpose statement is negative.
 - e. The Commission's approach to section 53P effectively ignores that the section 53P DPP reset provisions are deemed to apply to a situation where there is no existing DPP. In these circumstances a purposive and contextual approach to statutory interpretation is required, particularly where if that approach is not followed, absurd and anomalous consequences result.
57. In addition, even if section 53P(11) could be interpreted as unambiguous in its wording, which Vector submits is not the case here, it is clear Parliament did not intend CPI adjustments to be excluded from GPB starting prices should the Commission set the GPB DPP later than 30 June 2010 and, accordingly, strict meaning should yield to the purpose and context.
58. The Commission states that section 53P(11) does not apply because section 55F(2) does not apply to setting prices. Vector submits that whether or not section 55F(2) applies to setting prices is not the point in issue. The relevance of section 55F(2) is that it demonstrates Parliament's clear intention that uncontrolled GPBs be entitled to increase prices by CPI until the date of the first DPP determination. The Commission's interpretation is inconsistent with that intention.
59. Vector **recommends** the Commission: (i) reconsider its legal interpretation of the requirements for setting prices for uncontrolled GPBs; and (ii) adopt an approach where uncontrolled GPB prices are set at July 2012 levels not July 2010 levels. If the Commission's position remains that it has no choice but to exclude CPI adjustments, Vector **recommends** the Commission urgently refer the question to the Court under section 100A of the Commerce Act for a final view.
60. An alternative approach would simply be not to undertake a regulatory price reset under section 53P(B) until the beginning of the next regulatory period. Prices would continue to be capped at inflation under the first DPP (where the Commission is rolling over prices and proposing $X=0$). This would also avoid the problems that arise with undertaking mid-regulatory period

resets.²⁹ If the Commission maintains its proposed SPA approach, Vector **recommends** the Commission consider the option of not undertaking a mid-regulatory period reset as an alternative option to addressing the issue of whether prices would otherwise need to be reset at July 2010 or 2012 levels.

²⁹ See discussion in the subsequent section "Impact of mid-regulatory period resets".

SECTION 55F(4) RESET

61. In the Draft Reasons Paper the Commission indicates that while it is "rolling over" existing prices for the initial DPP, it may amend the DPP under section 55F(4) in the future.³⁰ This is permitted where a new IM is published that would have resulted in a materially different price path had it applied when the initial DPP was set. In these circumstances, the Commission has discretion whether or not to reset the DPP.
62. The Commission has commenced a separate consultation process regarding: (i) determination of the SPA IMs for Electricity Distribution Businesses (EDBs) and GPBs; (ii) whether or not to reset EDB DPP under section 54K(3); and (iii) whether or not to reset the GPB DPP under section 55F(4) (together referred to in this submission as the SPA IM/DPP consultation).³¹ In relation to the third issue, the Commission proposes to consult on whether or not to reset GPB DPPs under section 55F(4) "post 2012".³²
63. While Vector will be making further and full submissions on all issues in the SPA IM/DPP consultation, we set out below some initial key concerns regarding a potential section 55F(4) reset. These concerns are based on the Commission's proposed SPA methodology as set out in previous consultation.³³ (Vector notes here that the status of material in previous consultation remains unclear and it will be making further submissions on this point. Vector also notes the Commission may adopt a different approach to SPA IMs in the consultation process going forward.)
64. In previous submissions Vector has argued the Commission should delay any reset of GPB prices based on future and projected profitability until the next regulatory period. This was primarily because of the poor quality information currently available for GPBs.³⁴ This remains Vector's position. Vector sets out below additional and distinct issues regarding any section 55F(4) reset. These issues apply equally to a reset for EDBs.
65. The Commission has observed that "The rate at which we intend to share future efficiency gains when we reset prices in future will affect the strength of suppliers' incentives to achieve those efficiency gains before prices are reset."³⁵
66. One consequence of this is that consumers may be made worse off in the long-term if the Commission requires sharing too aggressively or too quickly in favour of consumers, because it is likely regulated suppliers would make less efficiency gains in the future and, accordingly, and there would be less scope for future price reductions or curtailment. Expressed in colloquial

³⁰ Paragraphs 7.21 - 7.23 of the Commerce Commission's Draft Reasons Paper "Initial Default Price-Quality Paths for Gas Pipeline Businesses", 21 November 2011.

³¹ Commerce Commission, Notice of Intention: Process for Determining Additional Input Methodologies for Electricity Distribution Services and Gas Pipeline Services, 29 November 2011; Commerce Commission, *Additional Input Methodologies for Default Price-Quality Paths: Process and Issues Paper*, 9 December 2011.

³² Commerce Commission, *Additional Input Methodologies for Default Price-Quality Paths: Process and Issues Paper*, 9 December 2011, para 32 and table 3.

³³ In particular, see Commerce Commission, Default Price-Quality Path for Electricity Distribution Businesses – Reset of Starting Prices, CPI Adjustment and Other Amendments Draft Decisions Paper, July 2011; Commerce Commission, Setting of Starting Prices for Gas Pipeline Businesses under the Initial Default Price-Quality Path: Discussion Paper, dated 22 August 2011.

³⁴ See Vector, Submission on the Commerce Commission's Initial Default Price-Quality Path for Gas Pipeline Businesses: Discussion Paper, 27 May 2011, para 117.

³⁵ Paragraph 167, Commerce Commission, *Additional Input Methodologies and Default Price-Quality Paths: Process and Issues Paper*, 9 December 2011.

terms, the Commission should be mindful that how the pie is shared can impact on the size of the pie.

67. The Commission has previously indicated efficiency gains would be taken into account through an SPA at each DPP reset. Despite this, the Commission's proposed SPA methodology did not take account of efficiency gains.³⁶ Vector has made various submissions on this issue, recommending the Commission include a staggered SPA and IRIS in order for its SPA approach to meet the Part 4 purpose.³⁷
68. While the Commission's choice of SPA IM, and its approach to claw-back, has a direct impact on incentives of regulated suppliers to improve efficiency, this impact is heightened in the case of a mid-period reset. This impact is illustrated in the stylised example below.

Stylised example

69. The impact of the Commission's proposed approach to price resets and claw-back can be highlighted by way of stylised example. To this end, Vector attaches a report "Efficiency impacts of Starting Price Adjustments – Stylised Example", 19 December 2011. This report sets out a stylised model which demonstrates the impact different approaches to SPAs can have on incentives of regulated suppliers to improve efficiency (subsection 52A(1)(b) of the Commerce Act).
70. Vector has adopted an example used by IPART^{38,39} in which a regulated supplier makes a permanent opex saving of \$1 million per annum. IPART used this example to show that the greater the period a regulated supplier is able to benefit from efficiency gains the greater the incentives they will have to improve efficiency:⁴⁰

A key determinant of the shape and strength of the incentive created is the time period over which the delinking occurs.
71. The IPART report then points out that "The regulator can adjust the strength of the efficiency incentive, that is, alter the incentive rate, by choosing a longer retention period."⁴¹
72. In this stylised example Vector assumes:
 - a. Efficiency gains are made at the beginning of the regulatory year.
 - b. The efficiency gains equate to a permanent opex saving of \$1 million per annum.

³⁶ In particular, see Commerce Commission, *Default Price-Quality Path for Electricity Distribution Businesses – Reset of Starting Prices, CPI Adjustment and Other Amendments Draft Decisions Paper*, July 2011; Commerce Commission, *Setting of Starting Prices for Gas Pipeline Businesses under the Initial Default Price-Quality Path: Discussion Paper*, dated 22 August 2011.

³⁷ See, for example, Vector, *Submission to Commerce Commission on Draft Decision on Starting Price Adjustments for Electricity Distribution Businesses*, 24 August 2011; Vector, *Submission to the Commerce Commission on the Setting of Starting Pricings for Gas Pipeline Businesses under the Initial Default Price-Quality Path*, 28 September 2011.

³⁸ IPART Working Paper "Incentives for cost saving in CPI-X regimes", July 2011, available at: <http://www.ipart.nsw.gov.au/files/Working%20Paper%20-%20Incentives%20for%20cost-saving%20in%20CPI-X%20regimes%20-%20July%202011%20-%20Website.PDF>

³⁹ A similar example is used by Frontier Economics in Appendix 5 of the National Audit Office report "Pipes and Wires", 10 April 2002 <http://www.frontier-economics.com/library/publications/frontier%20paper%20-%20incentives%20-.pdf>

⁴⁰ Page 4 of IPART Working Paper "Incentives for cost saving in CPI-X regimes", July 2011.

⁴¹ Page 9 of IPART Working Paper "Incentives for cost saving in CPI-X regimes", July 2011.

- c. There is no cost to making the efficiency gain.
 - d. The regulatory period is five years.
 - e. The WACC is 8%.
73. The NPV of the efficiency gain is approximately \$11 million.
74. The NPV of the benefit to the regulated supplier from making the efficiency gain under the Commission’s proposed SPA is detailed below. If the efficiency gain is made at the beginning of the five year regulatory period the regulated supplier would receive a maximum of 36.1% of the efficiency gain they create.⁴² Frontier Economics describes this measure of efficiency sharing as “incentive power”, with the incentive power under rate of return regulation being 0 and the incentive power of a perfectly competitive market being 100 percent.⁴³

Year of efficiency gain	1	2	3	4	5
NPV of Benefit to regulated supplier from efficiency gain (000)	\$3,993	\$3,067	\$2,209	\$1,416	\$680
Incentive Power/share of efficiency gains	36.1%	27.8%	20.0%	12.8%	6.2%

Impact of Commission's approach in context of section 55F(4)

75. The Draft Reasons Paper indicates the Commission intends to undertake a regulatory price reset in July 2013, with a 4 year 3 month regulatory period commencing in July 2012. This is effectively equivalent to setting two regulatory periods; the first a one-year regulatory period and the second a 3 year 3 month regulatory period.
76. The share of any efficiency gain a regulated supplier would make between July 2012 and July 2013 would be a maximum of 6.2% dwindling further to zero the closer to July 2013 the efficiency gain is made. (The efficiency gain could be zero if the Commission resets prices at July 2013 using cost information from the July 2012/13 financial year. This is because the costs the Commission would use to reset prices would take into account efficiency gains already made during the regulatory period.⁴⁴)
77. For the period between July 2013 and October 2016, the maximum share of any efficiency gain the regulated supplier would earn would be capped at 23.1%.The share would be smaller still or negative if there was any cost incurred to achieve the efficiency gain.
78. Vector does not believe such shares are “consistent with outcomes produced in competitive markets”, as required by the principle component of the purpose statement in s 52A(1) of the Commerce Act. Nor are they adequate for ensuring regulated suppliers have incentives to innovate (s 52A(1)(a) of the Commerce Act) or improve efficiency (s 52A(1)(b)). As the Commission itself has noted “the faster the rate of sharing efficiency gains with

⁴² The percentage share would be substantially less if the regulated supplier incurs costs to make the efficiency gain.

⁴³ Paragraph 18 of Frontier Economics in Appendix 5 of the National Audit Office report “Pipes and Wires”, 10 April 2002 <http://www.frontier-economics.com/library/publications/frontier%20paper%20-%20incentives%20-.pdf>

⁴⁴ Refer to paragraph 188 of the Commerce Commission’s Process and Issues Paper, Additional Input Methodologies for Default Price-Quality Paths, 9 December 2011.

consumers, the weaker the incentive for businesses to make efficiency gains".⁴⁵

79. The fundamental problem is that a price reset part way through a regulatory period compounds the extent to which the Commission's proposed approach to Part 4 of the Commerce Act is likely to limit incentives to innovate and improve efficiency. Even in the best case scenario with no mid-period price reset, no cost to making the efficiency gain, and the efficiency gain being made at the start of a 5 year regulatory period, the regulated supplier would only receive a 36.1% share of the efficiency gain.
80. It could fallaciously be argued that so long as a regulated supplier gets some benefit from improving efficiency they will, operating as a profit maximising firm, seek to make those efficiency gains, even if they only receive a small amount of the gains. This statement is only true if the efficiency gain results in an increase in profits. An increase in efficiency will not necessarily result in an increase in profits where: (i) the efficiency gains are shared between consumers and the regulated supplier; but (ii) the regulated supplier bears the cost.
81. It should be borne in mind that the above example assumes making the efficiency gain is costless. In reality this will not be the case. There will be financial and resource (effort of employees) costs in making efficiency gains.
82. Jamasb and Pollitt have made the point that improving efficiency can require initial increases in capex and/or opex:⁴⁶

Achieving long-term efficiency improvements can involve short-term increases in Capex and/or Opex expenditures that may not generate immediate efficiency improvements. Indeed, short-term expenditure increases can deteriorate the firms' short-term relative performance. This can in turn prevent firms from embarking on efficiency improving investments that have long-term gains.

83. If the assumption that there is zero cost to improving efficiency is removed the detrimental impact the Commission's proposed SPA approach will have on incentives to improve efficiency becomes stark. Vector demonstrates this by amending the stylised example to assume there is a one-off cost incurred of \$5 million, that it is not able to pass-through to consumers, to extract a \$1 million per annum improvement in efficiency. The initiative will still be efficient as it has an NPV of \$6.4 million, and therefore should still go ahead.

Year of efficiency gain	1	2	3	4	5
NPV of Benefit to regulated supplier from efficiency gain (000)	-\$637	-\$1,220	-\$1,760	-\$2,260	-\$2,772
Incentive Power/share of efficiency gains	-9.9%	-19.0%	-27.4%	-35.2%	-42.4%

84. It can be seen that the Commission's proposed approach to price setting could remove any incentives to improve efficiency (and result in substantial disincentives). If the regulated supplier were to make an efficiency gain at the start of July 2013, they would incur the full cost but only receive the benefit for 3 years and 3 months.

⁴⁵ Commerce Commission, *Regulation of Electricity Lines Businesses: Discussion Paper*, 21 March 2002, para 8.63.

⁴⁶ Tooraj Jamasb and Michael Pollitt, University of Cambridge, "Incentive Regulation of Electricity Distribution Networks: Lessons of Experience from Britain", 13 February 2007.

Appropriate approach to efficiency incentives

85. A major part of the problem with a section 55F(4) regulatory reset is that, under the Commission's proposed SPA, it exacerbates the small reward regulated suppliers would receive for efficiency gains, further weakening incentives to improve efficiency. These problems would not be so acute if the Commission adopted a staggered SPA and/or IRIS.
86. A staggered SPA and IRIS both aim to ensure regulated suppliers have incentives to improve efficiency, but in different and complementary ways:
 - a. A staggered SPA aims to help ensure incentives to improve efficiency by extending the period during which the regulated supplier is able to keep the efficiency gain;
 - b. IRIS is intended to ensure the incentive to improve efficiency remains constant throughout the regulatory period. Absent IRIS, regulated suppliers incentives to improve efficiency are highest at the beginning of the regulatory period and then decline over the regulatory period.
87. Vector **recommends** the Commission consider: (i) the impact of a section 55F(4) reset on incentives to improve efficiency (in the context of the SPA IM adopted); and (ii) whether the Commission should delay any price reset to the beginning of the subsequent regulatory period rather than undertake a mid-period (having regard to (i)).

CLAW-BACK (s 55F(4))

88. The Draft Reasons Paper factually observes that the Initial DPP “allows the option of claw-back to be applied, if prices are reset under s 55F(4)”.⁴⁷ The Draft Decision Paper subsequently states that “If we do reset the Initial DPP then our current expectation is that, subject to consultation, we would be likely to exercise the discretion provided in s 55F(4) to apply claw-back from the start of the regulatory period.”⁴⁸ The Commission subsequently made a similar statement in its “Additional Input Methodologies and Default Price-Quality Paths: Process and Issues Paper, 9 December 2011,”⁴⁹ although it clarified further when the claw-back would apply from.
89. Vector **notes** the Commission has provided no reasons why claw-back is “likely”. Vector speculates the Commission’s rationale is that the delay in price resets, caused by the Commission having not set IMs for DPPs and SPAs, could result in wind-fall gains to regulated suppliers ie if prices are higher than they otherwise would be from 1 July 2012 until the time the reset actually occurs.⁵⁰
90. Vector has substantial concerns about the Commission’s indication claw-back is likely. While Vector will make further submissions on this point as part of the SPA IM/DPP consultation, its initial concerns are set out below.
91. Vector considers it premature for the Commission to draw a conclusion that it should adopt claw-back or that claw-back would be “likely”. As Vector discussed in relation to the potential section 55F(4) reset, the Commission should make decisions on mid-period price resets, claw-back, SPA methodologies (including staggered SPA) and IRIS in a holistic manner, which fully recognises that the share of efficiency gains regulated suppliers receive will affect their incentives to improve efficiency.
92. The Commission should consider whether to introduce claw-back in the context of its proposed SPA and mid-period regulatory reset which already makes regulated suppliers’ share of any efficiency gains very small.
93. For the avoidance of doubt, Vector has the following views on claw-back:
- The merit and rationale for claw-back depends on the particular circumstances of a regulated supplier; in particular whether the prices it has operated under have, in of themselves, resulted in the regulated supplier earning excessive profits or failing to earn a commercially-sustainable rate of return.
 - The Commission could take an asymmetric approach to claw-back where it adopts claw-back for regulated suppliers unable to earn a commercially-sustainable rate of return under pre-existing prices but not for other regulated suppliers.
 - Application of full claw-back (to remove supranormal profits) would heighten the risk the prices the Commission set are inadequate for regulated suppliers to earn a commercially-sustainable rate of return.

⁴⁷ Paragraph X.11 of the Commerce Commission’s Draft Reasons Paper “Initial Default Price-Quality Paths for Gas Pipeline Businesses”, 21 November 2011.

⁴⁸ Paragraph 7.22 of the Commerce Commission’s Draft Reasons Paper “Initial Default Price-Quality Paths for Gas Pipeline Businesses”, 21 November 2011.

⁴⁹ Paragraph 174, Commerce Commission, Additional Input Methodologies and Default Price-Quality Paths: Process and Issues Paper, 9 December 2011.

⁵⁰ Or further losses if they are currently unable to earn a commercially-sustainable rate of return.

- d. Application of full claw-back would remove any share of efficiency gains regulated suppliers make. The incentive shares in the stylised example used above would either be zero (if achieving efficiency gains is costless) or negative (where there is a cost to making efficiency gains). This could signal that price control under Part 4 will be operated as if it is rate of return regulation, and severely dampen incentives to improve efficiency.
 - e. The Commission would need to consider, if it were to adopt claw-back, the extent of the claw-back that would be appropriate, including: (i) how far back in the regulatory period should the Commission apply claw-back; and (ii) should it apply claw-back that removes all losses or all profits above (its calculation of) WACC?
94. Vector **recommends** the Commission consider the impact of claw-back on: (i) the incentives to, and rewards for, efficiency gains; and (ii) the risk that regulated prices will be insufficient to enable regulated suppliers to earn a commercially sustainable rate of return.

CONCLUDING REMARKS AND RECOMMENDATIONS

95. Vector recognises the Commission faces a number of challenges and difficulties in establishing and transitioning to a new regulatory regime under Part 4 of the Commerce Act. The Commission has dealt with some of these challenges in a pragmatic and positive way; notably the overlap between regimes for GPBs subject to Gas Authorisations and adoption of an initial 4 year and 3 month regulatory regime.
96. There are three main areas in the Commission's Draft Reasons Paper Vector believes could be improved upon; these are (i) fine-tuning the service quality standards; (ii) revising the Commission's interpretation of how the regulatory price reset would apply to non-regulated gas pipeline businesses; and (iii) how the Commission ensures regulated suppliers have incentives to improve efficiency. These are each discussed below.

Service quality standards

97. The Commission has provided sound reason for coupling a threshold that 80% of ERTs are within one hour, with a 100%/180 minute threshold. The 100% threshold creates a problem though that there may be some circumstances where a 180 minute ERT is not realistic.
98. Vector believes the Commission should include a force majeure clause whereby the Commission has discretion to exempt certain breaches of the 180 minute threshold where the Commission considers that 180 minutes was not reasonably achievable. This would not impact GPBs' incentives to attempt to comply with the 180 minute threshold as they would not know, ex ante, whether the Commission would grant the exemption.

CPI adjustments for uncontrolled GPBs

99. Vector agrees with the Commission that it would not be desirable to reset non-regulated GPBs' prices from July 2012 back to July 2010 prices. It would be a perverse outcome for regulated suppliers not subject to Gas Authorisations to be penalised with prices reset at levels from two years prior without compensation for subsequent inflation.
100. Removal of the affect of two years inflation would not be "consistent with outcomes produced in competitive markets", could damage GPBs' ability to earn a commercially-sustainable rate of return and could also be detrimental to incentives to invest, in violation to the Commission's statutory objective.
101. With respect, Vector believes the Commission has erred in its interpretation that the relevant statutory provisions do not allow indexation from July 2010. Vector has provided, in some detail, an alternative statutory interpretation which it believes is correct and allows the Commission to include CPI adjustments from 2010 to 2012.
102. If the Commission does not agree with, or is uncertain about, Vector's statutory interpretation we strongly urge the Commission to urgently refer the question to the Court under section 100A of the Act for a final view.
103. An alternative approach would simply be not to undertake a regulatory price reset until the beginning of the next regulatory period. If this were to happen GPBs' prices would still be capped at inflation, consistent with the Commission's proposed $X = 0$, for the remainder of the current regulatory

period. This would also avoid the problems that could arise from undertaking mid-regulatory period resets.

Section 54F(4) reset and claw-back

104. Vector believes the prospect of mid-regulatory period resets and claw-back could have a chilling impact on incentives to improve efficiency, as well as exacerbating the risk regulated suppliers would not be able to earn commercially sustainable rates of return.
105. As the Commission is aware, Vector is concerned that the Commission is placing too much emphasis on ensuring regulated suppliers' are limited in their ability to earn excessive returns, and on aggressive sharing of efficiency gains with consumers, to the detriment of ensuring regulated suppliers have incentives to improve efficiency. Vector believes a long-term focus on ensuring incentives to improve efficiency would result in better outcomes (including lower prices) for consumers than a short-term focus on price reductions.
106. There are a wide range of Commission decisions that will impact on incentives to improve efficiency, including in relation to the SPA methodology (including a staggered SPA), IRIS, mid-period price resets and claw-back. Vector believes the Commission should take a holistic approach to considering how these mechanisms impact on incentives and how they interact with each other. For example, a decision to introduce a mid-period price reset along with claw-back would compound the weak incentives to improve efficiency caused by the Commission's SPA proposal and decision, to date, not to introduce an IRIS.⁵¹
107. The Commission should heed the warning of Berry and Evans about "the unsound Commission preoccupation with comparing short- to medium-term wealth transfers with medium- to long-term dynamic efficiency".⁵²
108. Vector does not believe it is desirable to adopt mid-period price resets or claw-back. If the Commission does introduce either or both of these, it should ensure incentives to improve efficiency are repaired through adoption of a staggered SPA and/or IRIS.

Recommendations

109. For the convenience of the reader, Vector's recommendations are repeated in full below:

Emergency Response Times

- a. Vector **recommends** the Commission adopt an exception clause to the ERT along the lines that "The Commission may grant an exemption to the 180 minute service quality cap for gas pipeline businesses if: (i) there are circumstances outside the GPB's reasonable control which the Commission is satisfied means imposing the 180 minutes cap would not be practicable or reasonable; and (ii) the extent of the breach of the 180 minutes cap was reasonable under the circumstances."

⁵¹ The Commission may need to reconsider these matters as part of its development of an SPA and DPP IMs. The Commission indicates some of these matters are open for further consideration in its "Additional Input Methodologies and Default Price-Quality Paths: Process and Issues Paper", 9 December 2011.

⁵² Mark Berry and Lewis Evans "The New Regulatory Regime for Electricity Lines Businesses: Great Expectations Unfulfilled", 26 September 2008.

CPI adjustments for uncontrolled GPBs

- b. Vector **recommends** the Commission: (i) reconsider its legal interpretation of the requirements for setting prices for uncontrolled GPBs; and (ii) adopt an approach where uncontrolled GPB prices are set at July 2012 levels not July 2010 levels.
- c. If the Commission's position remains that it has no choice but to exclude CPI adjustments, Vector **recommends** the Commission urgently refer the question to the Court under section 100A of the Commerce Act for a final view.
- d. If the Commission maintains its proposed SPA approach, Vector **recommends** the Commission consider the option of not undertaking a mid-regulatory period reset as an alternative option to addressing the issue of whether prices would otherwise need to be reset at July 2010 or 2012 levels.

Section 55(4) Reset

- e. Vector **recommends** the Commission consider: (i) the impact of a section 55F(4) reset on incentives to improve efficiency (in the context of the SPA IM adopted); and (ii) whether the Commission should delay any price reset to the beginning of the subsequent regulatory period rather than undertake a mid-period (having regard to (i)).

Claw-back (s 55F(4))

- f. Vector **notes** the Commission has provided no reasons why claw-back is "likely".
- g. Vector **recommends** the Commission consider the impact of claw-back on: (i) the incentives to, and rewards for, efficiency gains; and (ii) the risk that regulated prices will be insufficient to enable regulated suppliers to earn a commercially sustainable rate of return.