
# Cross-submission to Commerce Commission on *Gas Default Price-Quality Path: Issues Paper*

**31 May 2010**

## Introduction

1. Vector welcomes the opportunity to provide this cross-submission to the Commerce Commission ("**Commission**") on the submissions received on the *Gas Default Price-Quality Path Issues Paper*. This cross-submission responds to the submissions on the Form of Control section of the Issues Paper and the separate submissions on the remaining sections of the Issues Paper.

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## Form of control

*DPP for gas transmission businesses*

3. Vector disagrees with Maui Development Ltd ("**MDL**")'s view that it is not possible to set a DPP that meets the needs of both Vector (gas transmission) and MDL because the "business structures", particularly the contractual arrangements, of the two businesses are "very different". We note that default/customised price-quality regulation is intended to be low cost and this principle may not be met if one supplier consistently needs to apply for a CPP.

4. Subject to each firm having the ability to choose a price cap or a revenue cap form of regulation, the difference in business structures, notably the differing contract carriage and common carriage arrangements, does not mean that a DPP can only be suitable for one party. A DPP essentially consists of quality standards and a rate of change (any starting price adjustment is calculated on an individual company basis). There is no reason for the quality standard to be different for Vector and MDL. Nor do the differing business/contractual arrangements create such a difference between Vector and MDL that their relative productivity rates compared to the rest of the economy would be substantially different. The already acknowledged data and other difficulties in developing a robust X-factor for Gas Transmission Businesses ("**GTBs**") mean that it is highly unlikely that any productivity measure could be developed to such a fine scale to distinguish between Vector and MDL on the basis of their contractual arrangements. The Commission should set a rate of change and a quality standard that are consistent for both businesses.

*Contract carriage vs. common carriage*

5. Vector generally agrees with the other comments by MDL on contract and common carriage arrangements in place on our networks. However, we would make the following points to ensure the Commission has a good understanding of the different contractual models:

- Common carriage arrangements are better suited to a relatively short, unconstrained pipeline such as MDL's Maui Pipeline. In this case shippers have a high degree of certainty that they will be able to secure sufficient gas transmission capacity. It is less clear that common carriage would work for Vector's larger, more stringy and (in some areas) constrained pipeline network. The existence of medium and long-term gas transmission contracts on Vector's system and the reluctance of customers to surrender their contractual rights at this time suggest that customers support a contractual regime on Vector's network. Vector is currently investigating options for reforming our access regime and will shortly publish a discussion paper to industry participants.

- While contract carriage may in theory provide for more income stability, a significant portion of contracts on Vector's gas transmission pipelines have durations of one year – the term provided pursuant to the Vector Transmission Code (VTC). The income stability provided by contract carriage therefore reduces significantly over time and is considerably shorter than the five-year regulatory period.

- The "perception" that contract carriage may encourage shippers to purchase firm capacity and then sell at a profit to other shippers on a secondary market is not borne out by experience. There have been very few transfers of capacity on Vector's system. If a secondary market were to be in operation, however, that would not necessarily be a problem – capacity would simply be transferred to the party which valued it the most. It would be unlikely that Vector would benefit (or lose out) from such arrangements.

- Vector would also caution against viewing contract and common carriage (as applied in the New Zealand gas transmission sector) as polar opposites. As noted above, some of Vector's contracts are as short as one year while MDL has the ability to introduce "Authorised Quantities", which they describe as a quasi firm carriage system, on their pipeline. In our view, neither business can be seen as "purely" common carriage or contract carriage and while they clearly lean in one direction or another, they both sit on the same spectrum of contractual options.

*Price cap and revenue cap*

6. Vector does not agree with MDL's view that consumers would necessarily prefer a revenue cap arrangement. They may prefer a price cap on the grounds that it would protect them from the risk of price increases due to a major customer ceasing to take gas from the network.

7. Vector notes MDL's view that a wash up mechanism will necessarily be in place under a revenue cap whether specified or not, apparently assuming that both penalties and rewards will be in place under revenue cap regulation. In Vector's view, while there are penalties within the Commerce Act 1986 for over-recovery, there is no provision for "rewards" for under-recovery so it cannot be assumed that rewards and penalties are symmetrical. Based on Vector's experience, Vector would prefer to rely on known data and therefore recommends that historical quantities, rather than forecasts, are used. If lagged historical quantities are used then there will be less need for a wash up mechanism.

8. Vector notes MDL's view that under a price cap regime where a GTB is vertically integrated with gas distribution businesses and electricity retail businesses those downstream businesses provide a natural hedge against shifts in demand. MDL's reasoning in support of this view is that the GTB's downstream operations will pay the reduced rate when its pipeline business under-recovers due to reductions in demand. Vector sees this matter rather differently. Firstly, Vector has no involvement in any electricity retail business, although we do operate a gas wholesale business. Secondly, gas transmission costs are likely to be treated as a pass through for any gas distribution business so a change in gas transmission costs has no direct impact on the revenue of a gas distribution business. Thirdly, under a price cap a reduction in demand will not reduce prices, just the volumes demanded. The prices paid by a retailer for the volumes used will remain unchanged. We therefore do not consider that our downstream gas and electricity operations provide any kind of hedge against shifts in demand at gas transmission level.

9. We note that MDL has proposed that if a price cap form of regulation is retained, its asset beta should be increased by 0.1. Vector has sought advice on this issue from its expert advisers, Synergies Economics. They have advised as follows:

1. In our previous work undertaken for Vector, the beta estimate was based on US firms (given this is the only jurisdiction where there is a sufficient number of listed firms to enable such an analysis). As most US firms are subject to rate

of return regulation, based on the approach applied by Lally, an adjustment was then applied to beta for the difference in the regulatory regimes. Lally did not consider whether any such adjustment would be applied for a revenue cap.

2. In theory, a price cap form of regulation should expose the business to higher systematic risk compared to a revenue cap due to volume risk (depending on the extent to which volume risk is systematic, or non-diversifiable, in nature). In practice, however, the difference in beta has not been able to be reliably quantified. It is possible that the difference is not sufficiently material to warrant an adjustment in beta.

3. For example, no such adjustments have been explicitly applied in Australia, where firms in the same industry have been subject to revenue and price caps. The Australian Energy Regulator recently formalised a decision that it will make no adjustment to the betas applied to electricity transmission and distribution businesses for differences in the form of regulation. We expect that practice will similarly be applied to gas businesses.

4. Therefore, while MDL's proposal is not unreasonable in theory, it is not possible to determine if its proposed increment of 0.1 is reasonable. Without having sighted the KPMG report, it is possible that the proposed adjustment is arbitrary (for example, it could be based on one-half of Lally's proposed adjustment of 0.2). Further, we do not have information regarding the beta the increment is being applied to. If that beta already assumes a price cap (as per Lally's method), no further increment should be added.

5. …we would argue against any such [increment] on the grounds that there is a lack of reliable empirical evidence: (1) confirming that the difference is sufficiently material to warrant an adjustment; and (2) enabling such an adjustment to be reasonably quantified. This is particularly important because while differences in systematic risk may exist in theory, they need to be sufficiently material to warrant an adjustment in beta. Any arbitrary adjustment increases the risk of a regulatory error being made.

10. On the basis of that advice, Vector is unconvinced that any adjustment to the Asset Beta should be made solely due to the difference between a revenue cap and a price cap.

*Pass-through costs*

11. Vector strongly agrees with MDL that any balancing gas costs incurred by GTBs (i.e. establishment and ongoing costs of operating a balancing agent) should be treated as pass-through costs. Balancing costs arise from shipper mismatches

and are outside the control of GTBs. Upstream reconciliation costs should be passed through for similar reasons.

12. Industry levies, local authority rates, transmission charges and the costs of implementing new regulations should also be passed through. The Gas Industry Company (GIC) is increasingly developing new regulatory solutions in the gas sector and these often impose costs on participants. It would be an asymmetric sharing of risk to require the full costs of new regulations to be borne by industry participants (at least until the next reset) when they were not considered at the time of the starting price adjustment and X-factor determination.

**Quality standards**

13. Vector notes the wide variety of comment on setting quality standards for gas pipeline businesses, with no two submitters expressing the same view. This suggests that there is no obviously preferable means of measuring quality for Gas Pipeline Businesses ("**GPBs**"), which clearly makes the Commission's task of selecting and implementing a credible and robust quality standard all the more challenging.

14. Vector re-iterates the point made in our previous submission that the Commission should use this regulatory period to gather robust data on quality and reliability performance of GPBs and use these data to set credible quality standards (or, preferably, an s-factor) at the 2017 reset. Any quality measure selected for this regulatory period will most likely be sub-optimal. The Commission should therefore take a flexible approach to monitoring and enforcement of any apparent breaches. Further, the Commission should not set a large number of quality standards as a large number of quality measures creates compliance costs with little consumer benefit. A maximum of two standards should be set and information disclosure should be used as the means of gathering information on other performance metrics.

*Gas transmission quality standards*

15. Vector would also like to clarify our views on quality standards for gas transmission. In our previous submission we noted that we collect information on compressor uptime. However, we have now become aware that this information has only been collected for the past 1-2 years so we are not in a position to provide sufficient data to develop a quality target based on average historical performance for this metric at this time.

16. The proposal to use the number of times a supplier fails to meet pressure thresholds remains a reasonable measure in principle. However, SAIDI is a derivative of this (as a failure to provide sufficient pressure will often result in a loss of supply from a gas transmission network) and SAIDI data is what is currently available as it has been reported through information disclosures. Therefore SAIDI will be a more appropriate measure for the first regulatory period. Vector acknowledges that we have argued against the use of SAIDI as a quality measure for gas distribution in our Gas DPP Issues Paper submission. Many of the concerns we raised also apply to gas transmission. However, we are proposing SAIDI as a measure for gas transmission due to the lack of other quality measures that would be preferable and for which sufficient credible data is available to set quality standards for this regulatory period.

*Measuring compliance with gas transmission and distribution performance standards*

17. Whatever measure is chosen, the relatively low number of events and data quality issues means that it remains challenging to set a target for compliance purposes, with a standard deviation band or similar mechanism to avoid technical breaches. A five-year rolling average may be a way of negating the high annual volatility inherent in some gas quality data, while still exposing any downward trends over time.

**Pricing arrangements prior to the initial DPP**

18. Vector notes there is unanimous agreement amongst submitters that the "CPI Criterion" should be calculated over the entire period from 1 January 2008 until the date of the determination (or 1 October 2011 as the last likely date at which prices will change before the determination is made). As noted in our previous submission on the Gas DPP Issues Paper, the CPI Criterion should not be calculated over any sub-periods as was proposed by the Commission.

19. Vector does not agree with MDL that the CPI Criterion should be linked to revenue rather than price (at least, such an approach should not be applied to Vector). Section 55F(2) is clear that it is the change in weighted average prices that is relevant, not the change in revenues. As previously outlined to the Commission, Vector has taken steps to ensure that our weighted average prices do not increase by more than CPI. Any retrospective change at this stage to measure the CPI Criterion for Vector on the basis of revenue changes rather than price changes would risk technical breaches and fail to meet the requirements of the Act.

**Annual Assessments and Regulatory Periods**

20. Vector notes that Powerco strongly support starting the assessment period and regulatory periods on 1 October, while neither MDL nor GasNet have particular concerns with that approach. Vector considers that there is strongest support in the industry for a 1 October start to assessment and regulatory years and the Commission should therefore implement such an approach.