



19 September 2003

Ms Paula Rebstock
Acting Chair
Commerce Commission
44 - 52 The Terrace
P O Box 2351
WELLINGTON

Dear Ms Rebstock

CROSS-SUBMISSION ON GAS CONTROL INQUIRY CONFERENCE

Vector appreciated the opportunity to put its views on the gas control inquiry (Inquiry) to the Commission at the recent conference. In this cross-submission we wish to raise and emphasise a small set of issues in relation to:

- The competition test and market evidence
- Scope and process of the Inquiry
- The net public benefit test and estimating net benefits

The competition test and market evidence

Vector outlined in its written submission the primacy for this Inquiry of the competition test, as set out in section 52 (a) of the Act. At the conference we provided initial evidence that competition for gas distribution services in the Auckland market is not limited.

The Commission indicated interest in further information as to the nature and extent of competition for gas distribution services, including switching costs between energy types for commercial and industrial consumers. We are in the process of gathering and assembling this information and expect to be able to provide it to the Commission by late October. In the interim we would welcome the opportunity to engage with Commission staff and address any queries as required.

Scope and process of the Inquiry

In its written submission Vector raised a number of issues in relation to the scope and process of the Inquiry. The Commission's proposed process for the Inquiry does not involve it providing a response to these issues until March 2004, as part of its draft report. Vector considers these issues require clarification earlier, in order that affected parties are aware of the scope of the Inquiry and the procedures the Commission is intending to use when conducting the Inquiry. These issues are:

- Whether the Inquiry is a control inquiry (as set out in the draft Framework by the Commission), or a price control inquiry, and if the latter, whether and how that differs from a control inquiry (see paragraphs 5.4 –5.9 of Vector’s submission of 20 August 2003).
- Whether the scope of the Inquiry includes the retailing of gas, gas metering services, and other steps in the gas value chain in addition to distribution and transmission (see paragraphs 5.10 –5.27 and Appendix One & Two of Vector’s submission of 20 August 2003).
- The procedures the Commission intends to follow to conduct the competition test. We expect this exercise will involve the collection and interpretation of a large amount of market data. Procedures need to be developed to collect these data in an orderly fashion and ensure their accurate interpretation (see paragraphs 6.1 – 6.10 of Vector’s submission of 20 August 2003).

Vector requests the Commission clarify these issues prior to proceeding with the next steps of the Inquiry.

The net public benefit test and estimating net benefits

Vector wishes to raise two issues of method, should the Commission find competition is limited in some gas services markets and therefore needs to investigate whether control should be imposed. These two issues are the role of the net public benefit test in the Commission’s recommendation to the Minister, and the method it uses to estimate net benefits.

Net public benefit test

The Minister, in the Terms of Reference for the Inquiry, asked the Commission to consider the following issues:

“In reaching its view on whether control should be introduced, I ask for the Commission’s specific advice on:

- *whether gas pipeline services may be controlled in terms of section 52 of the Act;*
- *the methodology that the Commission considers appropriate for valuation of pipeline assets for the purposes of its advice on the matters covered in this letter;*
- *the net benefits to the public of control; and*
- *any other matter that the Commission may think relevant to a decision on whether control should be introduced.”*

Hence, the Terms of Reference require the Commission to have regard to the net public benefit *before* it reaches a view on whether control should be imposed under section 53. However, this is not reflected in the Draft Framework. Paragraphs 1.26 and 1.27, for example, state:

“In addition to the two key issues set out in section 52 of the Commerce Act the Minister has requested the Commission to give specific advice on the net benefits to the public of control. This reflects that wider considerations of economic efficiency may also be relevant to the Minister’s discretion whether to recommend control.

*"However, in making its recommendation to the Minister it seems clear that the two conditions within section 52... are the conditions that the Commission needs to be satisfied of. Therefore the Commission, **in making its recommendation to the Minister must confine its consideration to the net benefits to acquirers test.**" (emphasis added)*

VECTOR agrees that the Commission should satisfy itself that the tests under section 52 are met, as these are necessary but not sufficient conditions for it to recommend that control "should" be introduced. There is nothing in section 56 that requires the Commission to confine its consideration to the section 52 criteria, or more specifically, to the net benefits to acquirers of control.

Relative to the Airport Inquiry, the Minister has clearly widened the scope of the matters to be considered by the Commission in determining whether control should be imposed. Vector considers the Commission's method needs to be adjusted accordingly to incorporate the results of the net public benefit test within the Commission's recommendation to the Minister.

Estimating net benefits

The Commission indicates that it may consider an "alternative representation" of the net benefit analysis to that used in the Airports Inquiry, in which it would: (paragraph 5.242):

"...separately compare the costs and benefits of the factual and the counterfactual with the hypothetical benchmark of workable competition. Thus a comparison is made between two hypothetical future scenarios, one with control and one without, relative to workable competition."

Vector recommends the Commission adopt such an approach, as it would (correctly) recognise that the choice for the Commission and for the Minister is between flawed alternatives. Before recommending control, the Commission needs to satisfy itself that control (with all its faults) would result in a net benefit relative to the status quo (with all its faults).

The Commission should recommend control only if the net benefits (in expected value terms) of control are higher than the net benefits of no control, and by a substantial margin.¹ In Vector's view the approach proposed in the draft Framework raises the following concerns:

- The approach used in the Airports Inquiry does not allow for the uncertainty faced by the Commission. This uncertainty is not just about magnitude, but also whether effects would be positive or negative. Not addressing uncertainty in an explicit manner risks placing greater weight on more easily quantifiable factors than, for example, ongoing changes to incentive structures.
- The Commission should introduce an explicit step to recognise that its estimates of benefits are the maximum benefit theoretically available (between its

¹ Common law presumptions in favour of existing property rights, and the asymmetrical effect for consumers of regulatory error (i.e. under-investment is likely to be more damaging than over-investment), argue for increased regulation to be introduced only where the expected net benefit is substantial.

benchmark of workable competition and the status quo). In practice, control would achieve less than the theoretical maximum benefit even if control is well designed and implemented competently because of information problems, errors, time lags, and so forth. These issues that limit the quantum of benefits available in practice are in addition to the costs of control (e.g. distorted incentives).

- The costs of control may outweigh the benefits, leading to an estimate of a net detriment for control. The Airport Inquiry approach, by reducing benefits to take accounts of costs, cannot result in a net detriment estimate. This is misleading and unrealistic.
- The Commission argues that the costs of control can be assessed only when the nature of that control is made explicit (paragraph 5.279). VECTOR agrees, but notes that the same argument applies to the assessment of benefits.
- With respect to allocative efficiency, the method proposed by the Commission to estimate allocative efficiency gains would overstate the potential allocative efficiency gains from control for at least three reasons, as the approach assumes:
 - a. any prices above marginal cost would result in allocative efficiency losses that could be alleviated through price control, but under control prices would need to be set above marginal cost if gas services are to be sustainable over time.
 - b. gas distributors use a single, simple price, which is not the case.
 - c. the structure of prices would remain unchanged as a result of price control. This assumption is improbable. Price regulation is almost always based on average cost pricing, and often prohibits price discrimination. Such an approach is likely to reduce allocative efficiency relative to the status quo.
- With respect to productive efficiency, Vector agrees with the Commission's conclusion to paragraph 5.272 that "overall, it is possible (Vector considers probable) incentives for cost efficiency may be reduced rather than increased by control".
- In regard to dynamic efficiency, Vector is unaware of any argument or evidence that suggests that price control would foster innovation. However, there are good reasons for concluding that price control would dull incentives for innovation (for example by basing allowable return levels on average performance and thereby penalising successful innovators).
- In relation to the costs of control, Vector agrees that they should include both direct and indirect costs. However, the Commission's approach would understate substantially both the direct costs and indirect costs, as it does not take account of the opportunity cost of the resources devoted to administering and complying with control. These opportunity costs include:
 - a. the loss of value which management of the firm might otherwise have created if scarce management time had not been devoted to attending to the regulator's needs.
 - b. the gains that may have been realised from the Commission's resources being devoted to its next best alternative.
 - c. the economic costs of collecting the tax revenue which is used to fund the Commission's activities.

In Vector's view incorporation of the above points into any cost/benefit assessment would improve the reliability of the Commission's estimates, and by implication the reliability of any recommendation based on those estimates. However, as outlined in this letter and previous Vector submissions, the next step of this Inquiry needs to focus on the competition test, and proceed further only in those markets where competition is found to be limited.

Thank you once again for the recent opportunity to present to the Commission. We believe it would be valuable to further engage on the competition we face in the gas distribution business in Auckland and accordingly will be providing information to support this in the near future.

Vector would be happy to expand on any of the above issues.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Simon Mackenzie', written in a cursive style.

Simon Mackenzie
GROUP GENERAL MANAGER NETWORKS