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Steve Bielby
Chief Executive
Gas Industry Company
PO Box 10-646
Wellington

Dear Steve

Submission on the Proposed
Gas Transmission Investment Project

1. Vector Limited ("Vector") welcomes the opportunity to make this submission on the Gas Industry Company's ("GIC") proposed Gas Transmission Investment Project ("the Project").

2. Vector owns and operates 2,288 kilometres of high-pressure gas transmission pipeline across the North Island, among other energy and telecommunications networks. This transmission system delivers and brings the benefits of natural gas to local distribution pipeline networks and large industrial customers.

3. Vector is highly interested in issues of wide significance to New Zealand's gas industry and other energy related sectors. It is for this reason that Vector developed a Supplementary Submission addressing gas transmission investment as part of its submission to the Commerce Commission on the initial Default Price-Quality Path ("DPP") for gas pipeline businesses.[1]

4. Vector supports the concept of the proposed Project. As stated in our Supplementary Submission to the Commerce Commission the Regulatory Investment Test ("RIT"), which we proposed within the DPP, will not by itself promote investment incentives. Vector therefore considers that the proposed Project should be treated as the GIC's highest priority. Ensuring incentives to invest are critical to the efficient operation of the gas market and meeting the needs of the wider economy. The proposed Project should enable the GIC, other regulators, and market participants to achieve an informed, holistic understanding of the level of gas transmission investment required in the coming years.

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[1] http://www.comcom.govt.nz/assets/Gas/Gas-Default-Price-Quality-Path/Discussion-Paper-Subs/Vector-Submission-Initial-Default-Price-Quality-Path-for-Gas-Pipelines-Businesses-Discussion-Paper-27-May-2011.pdf

5. In particular, this submission discusses:

- incentives to invest in gas transmission (including by defining and coordinating regulatory responsibilities between the GIC and the Commerce Commission);
- improving the quality and availability of information;
- improving commercial arrangements; and
- project management.

6. We recognise the Project proposal is very high-level and we respond accordingly in this submission.

Ensuring incentives to invest in gas transmission

7. Vector believes the Project proposal should be guided by sound regulatory principles or guidelines that provide regulatory certainty and incentivise investment. These are crucial for the:

- continuation of service quality and performance reliability;
- safe operation of networks;
- provision of service to meet new consumer demand; and
- facilitation of new and innovative services.

8. A primary objective of the Project should be to determine when physical transmission capacity will become 'constrained'.

9. Another area that the proposal has failed to capture is the issue of regulatory enforcement of transmission pricing, which is required for investment certainty. As noted above, the RIT will not deliver certainty by itself and requires other commercial and regulatory issues to be addressed. Regulatory enforcement is required because we do not believe commercial arrangements are robust enough for lumpy investments that are subject to regulatory approval.

10. We also consider that the Project should identify the respective responsibilities of the GIC and the Commerce Commission (as discussed below).

Regulatory responsibilities

11. The GIC and the Commerce Commission have overlapping responsibilities that need to be identified and managed. Both regulators have objectives to ensure gas pipeline businesses have incentives to invest. Vector is concerned the involvement of the Commerce Commission is noticeably absent in the Project proposal.

12. Section 43ZN(b)(iii) of the Gas Act 1992 states that the objectives of the GIC include ensuring "incentives for investment in gas processing facilities, transmission, and distribution are maintained or enhanced" along with various

interrelated objectives. Similarly, section 52A(1)(a) of the Commerce Act 1986 states that an objective of the Commerce Commission is to ensure regulated utilities "have incentives to innovate and to invest, including in replacement, upgraded, and new assets" along with various interrelated objectives.

13. Clearly, regardless of whatever the GIC does, the Commerce Commission's operation of Part 4 of the Commerce Act will influence the incentives for Vector to invest in gas transmission.

14. At present, Vector does not have confidence it will be able to set and recover a commercially sustainable return on energy network investments under the Part 4 regulatory regime. This is part of the reason why Vector is appealing the Commerce Commission's Input Methodology decisions made pursuant to Part 4 of the Commerce Act.[2]

15. Section 43F(2)(d) of the Gas Act, as it currently stands, prescribes a somewhat draconian regulation-making power for "requiring expansions, upgrades, or service quality improvements to gas transmission pipelines including specifying how these will be paid for". Incentives to invest are not likely to be promoted if the gas transmission business could be forced to invest, with the allowed cost-recovery (which may or may not be adequate) imposed on the business.

16. Sections 54R and 54S of the Commerce Act provide a more satisfactory framework for grid investment approval but unfortunately this solely relates to electricity transmission. The Commerce Act is otherwise silent on investment approval for gas transmission.

17. Vector does not believe there is anything in the Commerce Act, however, that would preclude the Commerce Commission from adopting some kind of transmission investment approval mechanism, for example as part of the DPP (wherein such mechanism is currently excluded) or the Customised Price Path ("CPP").[3]

18. Vector considers that a key part of the GIC's proposed Project should be to determine what the respective responsibilities of the GIC and the Commerce Commission are, including a clear delineation of responsibilities, in relation to gas transmission investment.

19. If a suitable outcome cannot be found within the current regime, the Project <u>must</u> recommend a review of existing gas industry governance arrangements. If the Project determines legislative change is required, then it is expected that the

[2] http://www.vector.co.nz/news/vector-seeks-regulatory-certainty-for-investors-and-consumers-160211

[3] See Appendix A: Gas Transmission Investment and the DPP for a discussion on how the Commerce Commission could administer Part 4 to accommodate gas transmission investments.

Project would make this recommendation so that regulatory accountability is clarified.

Project aim

20. The vast majority of industry participants at the GIC workshop on transmission investment in April this year acknowledged that there is considerable uncertainty surrounding the economics of the natural gas market. This includes the economic rationale for, and magnitude of, the transmission investment required, if at all, to support uncertain and concentrated demand and supply sides of the gas supply chain. The Project proposal should reflect this uncertainty and the reality that investment can only occur when the right commercial and regulatory settings are in place. We propose the Project's aim to be recast, as follows:

> . . .Gas Transmission Investment Project aimed at establishing the current **and future** need for gas transmission investment and **creating an environment that enables efficient investments to occur, including sizing, timing and cost recovery**. ~~developing an effective pathway for gas transmission investment to take place.~~

Improving the quality and availability of information

21. The Project proposal should identify what information is required to demonstrate:

- that an upgrade or new investment is required;
- what size that upgrade or new investment should be (evaluating the relative merits of various options);
- the appropriate timing of the investment;
- how the investment will be agreed/approved; and
- how the cost of the investment will be recovered.

22. In 2010, Vector proposed that the GIC commission a study on the future demand for gas that the entire industry can use, similar to that in the electricity sector. We appreciate the GIC including this study in its work programme. Given the dearth of robust forecasts on the future demand for (and supply of) gas nationally, we propose that the delivery of this study be formally incorporated into the Project to inform decisions.

23. The GIC could draw some insights from the Statement of Opportunities ("SOO") process for electricity that was administered by the then Electricity Commission but is now the responsibility of the Ministry of Economic Development. The SOO was used as an input into the Grid Investment Test (the evaluation of which is now the responsibility the Commerce Commission) unless Transpower could demonstrate that other forecasting assumptions were more appropriate.

24. It is important that an independent view of the economics of future supply and demand is presented to the industry to facilitate the discovery of supply options, including the timing of the next major gas transmission investment. This should take into account lead times for designing, consenting, building and other processes required for a new transmission pipeline.

Improving commercial arrangements

25. Effective market arrangements are important to facilitate the efficient use of assets, particularly at times of (real or perceived) scarcity. Vector strongly supports the introduction of a capacity scarcity pricing mechanism that efficiently signals the value of new investment in pipeline capacity and effectively rations this scarce resource to its highest value use.

26. Consistent with the efficient and effective allocation of scarce resources, any proposed long-term arrangement <u>must</u> retain the right of commercial boards to allocate capital in the best interest of shareholders and continue to enable boards to fulfil the obligations of a responsible and prudent operator.

27. Short-term changes to current arrangements should be consistent with the long-term direction of the Project. Such changes should provide an appropriate transition to more efficient access arrangements that create an environment conducive to investment.

28. Vector <u>strongly prefers</u> market/industry-based solutions over rules/regulation to address the "short-term retail competition issues" raised by the GIC recently. The reallocation of scarce resources is most efficiently facilitated through the competitive allocation of capacity (e.g. through auctions or other forms of secondary trading) to those with the greatest need and willingness to pay.

29. A secondary market could exist under Vector's contract carriage arrangements. The benefit of this approach would include implementing changes that do not cut across existing contractual arrangements and with minimum changes, if any, to existing rules and regulations, thus preserving options for the longer term evaluation of current arrangements.

30. The form of carriage (i.e. common carriage, contract carriage, or a 'mixed' carriage regime) is a key consideration in any proposed market arrangements for the medium to long term. Vector has stated in its submission on the Commerce Commission's proposed initial DPP that it is not inextricably linked to contract carriage and, in the longer term, is open to a regime that would deliver material improvements in market efficiency.

Project management

31. Vector does not have significant issues with the proposed Project structure.

32. The proposed two-year timeframe for the appropriate regulatory arrangements to be put in place is fine in principle but may be optimistic. We would like to see progress sooner rather than later.

33. As noted above, it is important that the Project is highly aware of the Commerce Commission's work and recent and eventual decisions. To more formally establish this linkage, we recommend the appointment of a representative from the Commerce Commission to the Project's Technical Advisers group.

34. The Project should engage closely with the Electricity Authority to gain insights from the then Electricity Commission's experience with assessing Grid Investment Tests for the electricity sector before this responsibility was transferred to the Commerce Commission.

35. Vector will make a nomination to the Panel of Strategic Advisers.

Closing comments

36. Overlaps in the Commerce and Gas Acts mean potentially either, both or neither of the Commerce Commission and GIC could take responsibility for ensuring gas transmission investment occurs. We therefore <u>strongly recommend</u> that the Project proactively harmonise its work with the Commerce Commission's implementation of the new regulatory provisions of the Commerce Act. This would avoid duplication of work and unnecessary use of both regulators' and industry's scarce resources, facilitate an effective and efficient decision-making process, and provide much needed clarity for the industry.

37. Consistent with good international practice in respect of RITs, any investment should be proposed by the transmission system owner and approved by the regulator, with clear delineation of responsibilities between them. To ensure revenue security for a regulator-approved investment (i.e. a commercially sustainable return of and on the investment), an approved and legally enforceable pricing methodology would be required. Otherwise, the risk of future stranding would be too high, which would disincentivise investment.

38. Vector looks forward to providing feedback on further details of the Project proposal. Nevertheless, we would like to be assured that the Project will not prematurely lock in any investment pathway until regulatory responsibility is clarified and widespread buy-in from stakeholders is achieved.

39. For avoidance of doubt, even if the regulatory and commercial arrangements lead to investment certainty, the Vector Board reserves its right to allocate scarce capital resources, as appropriate.

40. Vector will continue to actively engage with the GIC, other regulators, and industry participants to deliver the certainty required by investors, users, and the Government in relation to gas transmission investment. We are highly committed to the success of this Project so the right commercial and regulatory environments are created to incentivise firms to efficiently allocate existing capacity and to efficiently invest in gas transmission systems.

41. We look forward to these engagements.

42. Should you have any questions, or require further information, please contact me at 04 803 9038 or Bruce.Girdwood@vector.co.nz.

Kind regards

Bruce Girdwood
Manager Regulatory Affairs

Appendix A: Gas Transmission Investment and Part 4 of the Commerce Act

43. Vector's gas transmission business will be subject to revenue (or price) control and quality regulation and information disclosure from 2012, pursuant to the regulatory regime set out in Part 4 of the Commerce Act. The DPP will determine price-quality paths that gas transmission and distribution pipeline businesses will be subject to, which will significantly impact on the level of returns that regulated businesses can obtain over the initial and subsequent regulatory periods.

44. In response to the Commerce Commission's consultation on its proposed initial DPP (mid-2012-2016), Vector made a Supplementary Submission on Gas Transmission Form of Control and Investment,[4] which proposed a Regulatory Investment Test ("RIT") within the DPP. We see this as one potential way of ensuring gas transmission businesses are able to invest in gas transmission.

45. Vector submitted to the Commerce Commission that the DPP should include a mechanism to accommodate the inherently lumpy and irreversible nature of gas transmission investments. This would provide a lower cost and timelier pathway for efficient investment to occur compared to going through a CPP. Under the Commission's current proposals, however, no allowance is made for gas transmission investment under the DPP. This means that Vector would have to apply for a CPP in order to proceed with any investment in gas transmission.

46. Under a CPP, the individual business will have to prepare, verify and consult on its CPP proposal, which will include justification that a CPP better meets its circumstances. This is more complex and time-consuming, and therefore a much more costly process than a DPP. A CPP is also more risky, for example, more onerous terms can be imposed and the extent to which the Commission may consider a proposal "prudent and efficient" is unclear. In addition, the requirements of the CPP process will inevitably delay critical investment. In short, the CPP process is not well suited to gas transmission investment. It is Vector's position that reliance on the CPP process will result in gas transmission investment being less likely to proceed.

47. On the other hand, a RIT within a DPP would provide sufficient flexibility and certainty for a gas transmission business that it can have the ability to recover the costs of its investments in a timely manner, while providing surety to the Commission that only reasonable and prudent investments would be undertaken. However, it was also noted in the Supplementary Submission that the RIT, as part of the DPP, by itself will not provide certainty of recovery without addressing market design and development, pricing methodologies, and contractual arrangements that enable the recovery of investment. This is important to provide certainty to investors that optimal investments will be paid for over time.

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[4] http://www.comcom.govt.nz/assets/Gas/Gas-Default-Price-Quality-Path/Discussion-Paper-Subs/Vector-Submission-on-Initial-Default-Price-Quality-Path-for-Gas-Pipelines-Businesses-Discussion-Paper-Appendix-1-RIT-and-Processes-27-May-2011.pdf