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Dear Ian

Submission on Retail Competition and Transmission Capacity Statement of Proposal

1. Vector Limited ("Vector") welcomes the opportunity to submit on the Gas Industry Company's ("GIC") Statement of Proposal ("SoP") on retail competition and transmission capacity.

Overview

2. Vector has assessed, based on reasonable and prudent operating criteria, that the Rotowaro north section of the North Pipeline is now operating at or near the limit of its physical capacity at peak times and, consequently, is unable to issue significant new contractual capacity whilst also meeting normal demand growth.

3. The GIC's SoP proposes rules that are intended to allow Shippers to compete for end-users by ensuring they have access to capacity when a pipeline is constrained. In the absence of significant new capacity being made available on the North Pipeline, the GIC considers the apparent lack of capacity trading between retailers to represent a deterioration in competition and a market failure.

4. As a reasonable and prudent operator and owner of the Northern Pipeline Vector does not allocate more capacity through its contracts than it can make physically available. Vector allocates capacity through an annual capacity allocation, which is capped at physical capacity at peak times and accounts for historical contractual arrangements.

5. During the period that Vector has had unallocated capacity (relative to physical limits at peak time), it has been able to meet its customers' incremental capacity requirements each year. During these times, the current capacity allocation mechanism has not created the perception of competitive disadvantage between

retailers - retailers have been able to secure sufficient capacity to service their changing requirements.

6. Once the capacity allocated through contract reaches physical capacity limits, the additional capacity requirements of Shippers' can only be met by investment to increase capacity or through the efficient reallocation of spare capacity between Shippers.

7. Reallocation of scarce resources is most efficiently facilitated through the competitive trading of capacity, in a secondary market, to those with the greatest need and willingness to pay. Under current contractual arrangements, this secondary market could exist between Vector customers.

8. The efficient trading of scarce resources would provide the price signals required to identify and justify efficient investment in new transmission capacity.

9. The issues of efficient allocation of scarce resources and the efficient investment in new capacity lie at the heart of the current debate.

10. Vector's preference is that processes through which scarce resources in the gas transmission sector are efficiently allocated and efficient investment decisions are made are considered within the broader context of the Gas Act, Part 4 of the Commerce Act and the Government Policy Statement on Gas Governance. By doing this, certainty will be created for gas suppliers and users and to investors in new gas transmission capacity.

11. Vector has engaged, and continues to engage, with Government officials, the regulators (including the GIC and the Commerce Commission) and industry participants to ensure the regulatory regime enables firms to efficiently allocate existing capacity and to efficiently invest, build and operate fit-for-purpose gas transmission systems with the certainty required by investors, users and government. Vector will, with the GIC and industry, be considering longer term improvements to access arrangements to support the desired investment environment.

12. The requirement that has driven the proposal for the SoP is to implement a "short-term fix" while regulators and industry consider the long-term objectives outlined above. Vector fully supports the GIC and industry participants considering Vector's regime for allocating capacity. However, we are not convinced that the details of the GIC's proposal have been fully analysed and therefore that the proposal will be effective as a transition, or precursor, to a long-term solution that addresses the underlying requirement for efficient competition and investment as required by relevant legislation and the Government Policy Statement.

13. Given Vector's concerns with the proposed SoP, it is impractical to provide detailed comments on the proposed options. While our concerns are outlined below, our

overriding concern is that the proposed options, if implemented, are likely to lead to unintended consequences and increased risk and cost for Vector and the industry with little evidence of the benefits exceeding the costs.

Problem Definition and Analysis – establishing a market failure warranting intervention

14. We are not convinced that the proposal has satisfactorily confirmed that there is a material competition problem or market failure. Nor are we convinced that it has confirmed that any of the proposed solutions would deliver a material efficiency gain through the resolution of any perceived market failure.

15. We note that submissions, in response to the GIC's Capacity Options Paper, May 2010, which claimed that competition in the retail market has diminished were, in the main, subjective and anecdotal. The GIC has not been able to provide sufficient objective, factual evidence to support these claims. In particular, we note that the evidence used to demonstrate an impairment to downstream competition is limited and tends to suggest that competition is continuing to the benefit of customers. We also note that a number of significant Shippers have submitted that no such competition issue exists.

16. Further, the need to establish a robust justification that competition is being materially impaired is reinforced by the fact that the GIC has recognised that:

    - only one section of the retail market is presumed to be affected - larger industrial and commercial parties which account for less than 22% of the gas market; and
    - the wholesale market is not affected.

17. In addition, Vector does not agree that end-user interest or dissatisfaction has been high. This is supported by the fact that we are unaware that Shippers, with surplus capacity, have been approached by other Shippers with requests for capacity trades, which is what would be expected if capacity was genuinely valued and being sought.

18. We also believe that the GIC has failed to follow "good regulatory" process contained within the Gas Act and also prescribed by Government policy.[1] In this regard, the GIC has, in Vector's opinion, not met the requirements of section 43N of the Act by not assessing all reasonably practical options for achieving the

[1] In this regard we note the recent Government Statement on Regulation: *Better Regulation, Less Regulation*, 17 August 2009. http://www.treasury.govt.nz/economy/regulation/statement. This statement speaks of resisting the temptation to make changes through regulation until a clear case has been made that regulations are required and also specifically mentions the need for a particularly strong case for regulation where private property rights are overridden.

objective of regulation and assessing the costs and benefits of each option. The cost-benefit assessment is deficient because it only assessed the costs, not the benefits and only assessed one option - the preferred option. The failure to assess the benefits of the preferred option is inconsistent with the cost-benefit analysis undertaken with gas transmission pipeline balancing where an attempt to model the benefits was made.

19. Under a section 43N(1) assessment, the GIC must also consider other matters it considers relevant when making a recommendation to the Minister. Vector is concerned that the current process creates the following risks:

- that proposed Rules could be disallowed because they would be challengeable by the Regulations Review Committee for impinging on and taking priority over contractual rights – Standing Order 310; and
- that the GIC, in hearing an appeal in relation to a "rule-conforming" VTC change request, would be deemed to have pre-determined the outcome.

20. In summary, based on the information provided, there is insufficient evidence that the current multilateral contractual arrangements are leading to inefficient outcomes, and it is unclear the proposed changes contained within the options will lead to more efficient outcomes. Consequently, we see a real risk that if one of the proposed suite of options is implemented, it will not lead to efficiency gains but a wealth transfer away from those retailers holding capacity to those that would require it under one of the proposed options. Consequently, if implemented, the proposal may result in a detrimental impact on allocative and dynamic efficiency.

A Proposed Way Forward

21. Given the lack of evidence of a real and material competition issue impacting on efficiency, Vector would prefer and support an evolutionary approach that does not implement changes that could have unintended consequences that could compromise the long-term objectives of efficient allocation of resources and efficient, secure investment in transmission capacity.

22. Such an evolutionary approach could be to facilitate the secondary trading of capacity. The benefits of this approach would include implementing changes that do not cut across existing contractual arrangements to the extent that the proposed SoP options do, and is likely to result in fewer changes to the VTC.

23. As a first step, it would seem sensible for the GIC to work with Vector and the gas industry to facilitate the efficient allocation of transmission capacity through secondary trading and to do this within the current contractual arrangements and with minimum changes to rules, regulations and the VTC.

24. This approach would:

- facilitate liquidity but would require arrangements to ensure transparency and participation;
- be achieved, as far as possible, under existing arrangements;
- minimise unnecessary value transfers;
- preserve the option for further justified intervention in the future; and
- provide an appropriate transition to more efficient access arrangements to facilitate greater competition and a conducive investment environment.

25. We recognise that the GIC, through its 2009 review undertaken by CreativeEnergy, assessed mechanisms to activate a secondary market. We recommend the GIC build on this initial work and, in consultation with industry, determine what changes would be required to promote secondary trading of capacity.

Closing comment

26. In Vector's view, the GIC has not clearly established and provided sufficient evidence of a problem in the market that impedes the achievement of the Gas Act and GPS objectives, nor has its assessed quantitatively the costs and benefits of the options in accordance with these objectives. It would therefore be inappropriate to provide detailed comments on the evaluation criteria.

27. We provide some comment on the proposal for the GIC to take into account if it considers this issue further. Our high-level comments on the options are contained in Appendix A.

28. We propose that the GIC instead consider an incremental, or evolutionary, approach to increasing the efficiency of current arrangements while considering the long-term development of access arrangements for the industry. This approach is based on creating the transparency and incentives necessary to encourage secondary trading of capacity between shippers.

29. Thank you for considering Vector's submission. We are happy to discuss any issues or questions you may have regarding our comments. Please feel free to contact John Rampton, Vector's Industry Governance and Policy Manager, at John.Rampton@vector.co.nz or 04 803 9036.

Kind regards

Allan Carvell
Group General Manager Regulation and Pricing

Appendix A: Vector's Comments on Short-Term Options

Option	Vector's Comments
General	We believe the options need to be further developed before the industry can make informed comments and, ultimately, decisions. As such, we cannot make an informed decision as to which of the options is the best way forward for Vector and the industry (with some notable exceptions in the interruptible and demand tariff space).
Option 1A – Permitted Demand	We note: • this option needs to be further developed; it appears to attach capacity to Permitted Sites such that it cannot be used elsewhere; • this option requires Vector to issue unlimited Reserved Capacity, which overrides Vector's RPO obligation but does not override Vector's service obligation. Any option, such as this, may result in increased demand on a constrained system and could ultimately lead to delivery failure and curtailment. Shippers should be aware of Vector's need to be protected from claims in relation to this; • this option may continue to incentivise Shippers to hold more Reserved Capacity than they need; we query the rationale for this; • a process for providing Vector with information on Permitted Sites will need to be developed; the Registry does not hold this information nor does Vector; • Vector currently deals with Shippers as opposed to end-users and would prefer to retain a consistent mode of operation (i.e. Shippers should apply for sites to be Permitted Sites); • defining Permitted Sites according to AQ only might not be sufficient; a seasonal load might result in the same volume across the year as a flat load, but with a daily load 2-3 times greater at certain times – having a much greater impact on transmission capacity;

Option	Vector's Comments
	• that Permitted Sites may not all need to be registered at the time of the declaration of a Constrained Pipeline; • transfers could in effect only occur in respect of Reserved Capacity relating to non-Permitted Sites; • the suggested use of the MCE as a basis for determining the cost associated with a Shipper exceeding the Permitted Demand at a Permitted Site, but we query the logic behind and appropriateness of this compared with, for example, a multiple of the CRF or other method; • declaration of a Constrained Pipeline is not necessarily straight-forward and details need to be provided as to what information would be required; • a tolerance over historical peak quantity would be unacceptable; • capacity that "becomes available" should not necessarily be issued to prospective Permitted Sites and considerable thought would need to be put into any queuing/priority rules – loads are rarely equivalent in nature; • this option might not lead to Shippers rescinding capacity.
Option 1B – Unlimited Premium Capacity	We note: • this option may not receive widespread support for the reasons suggested below; • the suggestion is that this option will limit or terminate demand growth, but Shippers can average out the cost of Premium Capacity so its impact could be diluted; • new entrants will be forced to buy Premium Capacity so efficiency may or may not be achieved; • the comments made above regarding service obligations and the use of the MCE also apply here.

Option	Vector's Comments
Option 1C – Firm Unauthorised Overrun	We note: • this option appears not to take into account the physical capacity constraint; • this option does not fully address the issue of Reserved Capacity being in the "wrong hands"; • the comments made above regarding service obligations and, in particular, that sections such as 4.23 are present for the protection of Shippers as well as Vector; our understanding is that Shippers do not want a reduction in service quality.
Option 2A – Tradable Power Station Capacity	We note: • Vector currently offers an interruptible service and Shippers for the most part do not appear to be interested in it or in paying a Reserved Capacity rate for it.
Option 2B – Interruptible Power Stations	We note: • this option may not be possible for technical reasons, for example, existing electricity transmission technical constraints, voltage support etc.
Option 2C – Liable Capacity	We note: • It is not possible for us to provide comments on this option because of the limited information provided regarding this option.

Option	Vector's Comments
Option 3 – Capacity Follows End User	We note: • we can only provide limited comments based on the information provided; this option appears to involve capacity following an end-user into a Shipper's portfolio but is not attached to an end-user from a usage perspective; • the determination around Reserved Capacity increases and decreases could be fraught with difficulty (and possible dispute, particularly if overruns result), will be very time consuming; and more information is therefore required as to how the GIC thinks this will work; • transfers are not denoted in GJ but in the $ value of capacity and the incumbent's historical position may not be the most relevant one; • it is not always clear that a Shipper will receive a Reserved Capacity increase.
Option 4 – Demand Tariff	We note: • this option involves a significant change and may not be appropriate as a short-term option.