

8 July 2013

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Dear Ian

31 MAY 2013 VECTOR TRANSMISSION CODE CHANGE REQUEST

- 1 This letter responds to your email of 24 June 2013 in which you welcomed any additional information on whether (and why) Vector Gas Limited's (*Vector*) consent to Contact Energy Limited's (*Contact*) Vector Transmission Code (*VTC*) Change Request has or has not been reasonably withheld.
- 2 In this letter, we:
 - 2.1 provide our view on the test to be applied in determining the appeal of Vector's decision to withhold consent to Contact's Change Request; and
 - 2.2 further explain the reasons we gave for withholding our consent, and why those reasons are reasonable.
- 3 We also record that we have provided to the Gas Industry Company (*GIC*) legal advice we received from Chapman Tripp relating to the appeals framework under s 25.6 of the VTC.

The test to be applied – "shall not be unreasonably withheld"

- 4 In determining an appeal made under section 25.6(a), the GIC must make a "finding that Vector has or has not validly withheld consent under section 25.5(b)".
- 5 Section 25.5(b) provides:

Vector's consent under section 25.5(a)(i) shall not be unreasonably withheld or delayed, and without limiting the previous part of this section 25.5(b), it will not be considered unreasonable for Vector to withhold its consent where the Change Request would:

- (i) require Vector to incur capital expenditure that Vector does not wish to incur or considers that expenditure to not be economically viable to incur;
- (ii) require Vector to incur operating expenses or costs that it cannot reasonably expect to recover; or
- (iii) be likely to adversely affect:
 - (A) the structure of Vector's transmission services, business structure or the structure or magnitude of Vector's transmission revenues; or

(B) the compatibility of Vector's Transmission System open access regime and the open access regime on the Maui Pipeline

- 6 In your email, you stated that it is the GIC's assessment that "Vector is not limited by the specific clauses listed under section 25.5(b) of the VTC to validly withhold its consent". We agree, noting that the words "without limiting the previous part of this section 25.5(b)" in section 25.5(b) make it clear that the list of reasons is not exclusive. In its letter of appeal, Contact left out the words "without limiting the previous part of this section 25.5(b)" from its quote of section 25.5(b). This likely explains why Contact has misinterpreted the section.
- 7 The words "without limiting the previous part of this section 25.5(b)" also clarify that the list of reasons do not colour or restrict what reasons can be considered to be reasonable or unreasonable. In other words, they are not an interpretive aid.
- 8 The test of whether consent has been unreasonably withheld is an objective one, and is determined by a two-stage inquiry:¹
- 8.1 First, what were the reasons for withholding consent;
- 8.2 Second, do those reasons provide reasonable grounds for withholding consent?
- 9 What may constitute reasonable grounds for withholding consent in the VTC is potentially open-ended, as apart from the "safe harbours" in the specific clauses in section 25.5(b), no indication of the scope of reasonableness is given. However, we believe the objectives in the Gas Act and Government Policy Statement on Gas Governance (*GPS*) are relevant, particularly given the GIC's mandate to determine appeals in the Memorandum of Understanding.² Reasons which are *bona fides* grounded in the Gas Act and GPS objectives should be considered reasonable. The GIC needs to be careful, however, that this assessment does not shade into a merits review i.e. an assessment as to whether the change request better promotes the Gas Act and GPS objectives than the status quo. It is a matter of determining whether the reasons given by Vector resonate with the Gas Act and GPS objectives and are not obviously unreasonable in those terms.
- 10 Furthermore, the scope of reasonableness should not be limited to the safe harbours and the Gas Act and GPS objectives. It would be reasonable, for instance, for Vector to withhold consent on the basis that a change request would be unlawful, or where the change request is so incompatible with Vector's strategy for its gas transmission business that consent can't be given. There may be other reasonable grounds that arise from time to time.

Vector's reasons

- 11 In our letter to Contact withholding consent, we gave our reasons for doing so. In summary, those reasons were:
- 11.1 the problem that the Change Request purports to address does not in fact exist;

¹ *Greymouth Gas Kaimiro Ltd v GXL Royalties Ltd* [2010] NZSC 117, para 10.

² *Memorandum of Understanding between Gas Industry Company Ltd and Vector Gas Ltd* (17 October 2008), clause 2.3.

- 11.2 the Change Request will create an inefficient change process which, among other things, will increase the cost for all parties and unnecessarily increase the GIC's workload;
 - 11.3 the Change Request will undermine the ability of the parties to the VTC – a commercial contract – to negotiate varied terms;
 - 11.4 the Change Request will hinder and potentially halt the implementation of wide ranging market reforms, such as those recommended by the Panel of Expert Advisors; and
 - 11.5 the Change Request will create ambiguity and uncertainty around what a "single issue" or "related series of issues", and this will result in more disputes.
- 12 For convenience, we restate our reasoning below. However, we also further explain our reasons and respond to some of Contact's comments in its letter of appeal.

No problem to be fixed

- 13 Vector is aware of the risk that the ability to propose package change requests (i.e. those dealing with multiple issues, not necessarily related) could be taken advantage of. However, the GIC is alive to the potential issues in dealing with package change requests and has managed the issues effectively in the past without an amendment to the VTC to restrict what change requests parties can and cannot make.
- 14 We have in mind the way the GIC dealt with Maui Development Limited's (*MDL*) 17 October 2009 change request. In that case, the wide-ranging nature of the change request made it difficult for the GIC to assess its net benefit and it was not supported because of the uncertainty in the assessment. We expect the GIC will continue to manage change requests in a similar way, although we do note that if all proposed amendments in a package change request are clearly positive, the GIC should have little problem in supporting the change request. The key is that the GIC is alive to this issue and is dealing with it in a common sense way.
- 15 It seems that the trigger for the Change Request is Vector's 27 November 2012 change request which proposed amendments to the VTC balancing arrangements. If that change request is the sort of perceived problem that Contact is seeking to address, then we are strengthened in our view that there is no problem to be fixed. As we explained in our submission on the GIC's draft recommendation supporting that change request, the amendments were aimed at maximising the efficiency of the new balancing arrangements, and were clearly related:³

The gains in efficiency will be generated by a set of balancing arrangements that implement a causer pays objective. Thus, the arrangements:

- (a) ensure that balancing costs are more accurately allocated to those parties whose actions (or inactions) cause the balancing costs. This is achieved by the amendments to replace the ILON process with a B2B process and also modifying the VTC to include the MPOC Peaking Charge; and

³ Vector *Submission on Draft Recommendation on 27 November 2012 VTC Change Request (Balancing)* (25 March 2013), pp. 1-2.

- (b) ensure that those parties allocated balancing costs are unable to avoid or delay paying those costs. This is achieved by limiting the scope for disputing invoices relating to balancing to circumstances where there is a manifest error.

16 In its appeal letter, Contact referenced two previous change requests where multiple issues were packaged together and were alleged to have caused difficulties. Two points are relevant here:

16.1 First, the GIC has previously noted that “bundled change requests are ‘riskier’ in the sense that it will take only one of the proposed changes to not be supported for a whole appeal not to be supported”;⁴

16.2 Second, it was this risk that led to both MDL’s 17 October 2009 change request and Vector’s 14 December 2011 change request not being supported by the GIC. Again, this shows that the GIC is managing this issue and has provided an appropriate deterrent to parties who would seek to take advantage of the process.

Change Request will create inefficient change process and increase cost

17 While we see no gain to be made from the Change Request which seeks to address a non-existent problem, there will be a number of costly consequences.

18 Most obviously, parties will incur greater costs in needing to formulate and assess a greater number of change requests. This is extra cost that is simply not necessary.

19 The workload of the GIC will also increase. Each change request appealed to the GIC requires the GIC to set an agenda, receive submissions and cross submissions, evaluate the change request, and write draft and final recommendations. The Change Request will increase that workload by multiples. This will result in increased costs and the diversion of scarce resources, and also longer timeframes for change requests to be assessed.

20 Vector cannot reasonably consent to a change request which it genuinely considers will increase costs for all parties for no certain benefit.

Change Request will undermine the ability of parties to a commercial contract to negotiate varied terms

21 The Change Request would undermine the nature of the VTC as a commercial contract. In a commercial contractual relationship, parties are free to negotiate varied terms. There is no restraint on what changes they can seek. The key is that parties have the freedom to suggest changes and make the trade-offs that are typical of commercial agreements.

22 Progress in a commercial context can be made by agreeing a package of unrelated changes that is acceptable overall to each party. This option should be available with the VTC. By constraining change requests to “single issues” or a “related series of issues”, parties to the VTC would lose the ability to advance trade-off solutions.

23 Contact suggests that commercially negotiated trade-off solutions would likely be a “related series of issues” and so could be included in a single change request. This is wishful thinking, but does give an insight into just how elastic and ambiguous the

⁴ GIC Draft Recommendation: VTC CR Appeal 31 July 2012 (1 October 2012), p. 13.

concept of a “related series of issues” is. Either the Change Request would put an end to commercially negotiated package solutions, or there will be more disputes about what is and what isn’t a “related series of issues”. Neither outcome is attractive.

Change Request will hinder and potentially halt wide ranging market reforms

- 24 The Change Request would undermine Vector’s ability to implement wide ranging market reforms, such as those likely to be required following any Panel of Expert Advisers (*PEA*) advice.
- 25 Vector expects that implementing such reforms would require multiple change requests, as the reforms would cover a number of discrete parts of the VTC. In the first instance, this will hinder the progress of the reforms by requiring large amounts of work to draft the change requests and, as would likely be the case, to be assessed by the GIC.
- 26 More fundamentally, it is possible that splitting up market reforms into multiple change requests would mean that the net benefits test could not be satisfied. The interdependent relationships between different amendments can generate the benefits – some amendments will simply not show benefits if their relationship with other amendments is arbitrarily severed by the requirement that change requests be limited to a single or related series of issues.
- 27 Contact suggests that a solution to this problem that the Change Request would cause would be to implement reforms through new regulation. If one result of the Change Request is the prospect of unnecessary and expensive regulation for the industry, it would be unreasonable for us, as a reasonable and prudent operator to consent to it.

Change Request creates ambiguity and uncertainty – disputes will result

- 28 Finally, we believe the wording of the Change Request is ambiguous, and will only give parties another opportunity to raise disputes.
- 29 Reasonable parties will differ on where they draw the line between single and multiple issue requests. For example:
- 29.1 was Vector’s 9 November 2010 “Typos” change request “multiple issue” because it addressed (albeit in a minor way) alignment of the Code with the requirements of the Gas (Downstream Reconciliation) Rules 2008, correction of several minor errors in the Code and clarification of inconsistencies regarding the requirement to have a Gas Transfer Agreement at an Inter-Pipeline Point?
- 29.2 as above, we don’t believe our 27 November 2012 change request was a multiple issue request, but Contact believes it to be;⁵
- 29.3 would Vector be able to save time and money by including some minor drafting clarifications in an otherwise unrelated change request?
- 29.4 would change requests be able to cover multiple sections of the VTC e.g. changes to section 4 (Capacity Reservation) and section 16 (Invoices and Payment) or would there need to be a separate change request for each section?

⁵ Contact Energy *Letter to GIC Re 6 May 2013 VTC Single Issue CR Appeal* (31 May 2013).

30 Contact acknowledges that the Change Request will provide a further ground for appeal to the GIC:⁶

This [i.e. the claim that the request relates to a single or related series of issues], like any other change request, can be appealed and the party making the change request risks the GIC finding against them.

31 This would lead to the GIC having to assess both whether a Change Request is a "valid" single/related series of issues request and whether it advances the criteria in the Gas Act and GPS. However, neither the VTC nor the Memorandum of Understanding between Vector and the GIC gives the GIC any authority to reject a Change Request it believes to "invalidly" contain multiple issues. The GIC may therefore find itself in a position where it must recommend a Change Request which it nonetheless finds to be "invalid". This would be an unsatisfactory process and would likely to lead to disputes.

32 Disputes over the application of the "single issue" rule could also be used tactically to frustrate the passage of efficiency-enhancing change requests.

33 If a party does not wish a Change Request to be adopted it would have 2 avenues available to it (i) appeal to the GIC, (ii) dispute that the Change Request contains only one issue or related series of issues. A Shipper may seek to prevent an efficiency enhancing Change Request from being adopted by disputing whether it covers a single issue or related series or issues. This can only slow down and frustrate the Change Request process, and given the ambiguity of the single/related series of issues test, we should expect this sort of gaming of the provision.

The Change Request is inconsistent with the Gas Act and GPS objectives

34 In short, our view is that there is no benefit to be had from pursuing a change request which seeks to address a problem which does not exist, and which has a number of costly and inefficient unintended consequences.

35 The key Gas Act and GPS objective relevant to the Change Request is "to ensure that gas is delivered to existing and new customers in a safe, efficient, and reliable manner".

36 The efficiency criterion is particularly relevant here. The Change Request is incompatible with the objective of efficiency principally because of the increased costs that it would create – that is, increased costs incurred from a multiplication of change requests which parties must formulate and which the GIC will need to assess, from increased disputes about what is and isn't a single issue or related series of issues change request, and from the inflexibility of the process where commercially negotiated trade-off solutions are foreclosed and the ability to implement market reforms is hindered.

37 Ultimately, we find it compelling that the GIC has used common sense to successfully deal with this issue in the past, and we see no reason to cut across that by imposing an inflexible hard and fast rule about what change requests can and can't be made. The costs of the unintended consequences of the Change Request would dwarf any perceived gains – gains which we don't believe are there to capture in the first instance.

⁶ Contact Energy *Letter to GIC Re 6 May 2013 VTC Single Issue CR Appeal* (31 May 2013).

Yours sincerely,

A handwritten signature in black ink that reads "K-Shufflebotham". The signature is written in a cursive, slightly slanted style.

Katherine Shufflebotham
Commercial Manager - Networks