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GasNet Limited  
8 Cooks Street  
PO Box 7149  
Wanganui 4541

Telephone; (06) 349 2050  
Fax; (06) 349 0135  
[www.gasnet.co.nz](http://www.gasnet.co.nz)

Dr Mark Berry  
Chair  
Commerce Commission  
P O Box 2351  
Wellington

[By email]

Dear Mark

## **Starting Price Adjustments for Default Price-Quality Paths**

1. The Commerce Commission (the Commission) published, in August 2010, a Discussion Paper<sup>1</sup> which outlines a possible methodology to be applied to determine starting price adjustments for default price-quality paths (DPPs). This paper applies to gas pipeline businesses (GPBs) and electricity distribution businesses (EDBs).
2. This submission reflects the views of GasNet on the Discussion Paper. GasNet is a limited liability company owned by Wanganui Gas Limited (WGL) which owns and operates gas distribution networks in Wanganui, Marton, Bulls, Flockhouse and Waitotara located in the Central North Island. GasNet's combined distribution systems are 366 kilometres long, with approximately 10,300 connected customers.
3. Our comments are limited to the implications of the proposals set out in the Discussion Paper for gas distribution businesses (GDBs). We have not considered the proposals as they may apply to either EDBs or gas transmission businesses (GTBs).
4. In responding to the Commission's various consultation papers on the implementation of the regulatory provisions of Part 4 of the Commerce Act to GPBs, GasNet has stated a number of times that our primary objective is to work with the Commission to ensure that the development and application of the regulatory framework does not impose regulatory costs on our business which

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<sup>1</sup> Commerce Commission, Starting Price Adjustments for Default Price-Quality Paths, Discussion Paper, 5 August 2010

outweigh any benefits to consumers. GasNet is small in the context of the gas distribution sector<sup>2</sup>, and it remains GasNet's view that the regulatory compliance burden under the new Part 4 of the Commerce Act is likely to be significantly higher than that it currently incurs.

### **Consultation to Date**

5. Over the past 18 months GasNet has actively participated in the Commission's consultations on:

- The regulatory provisions of Part 4 of the Commerce Act;
- The input methodologies (to be applied in all forms of regulation to apply to GDBs);
- Information disclosure regulation (IDR); and
- The initial DPP for GPBs.

6. Our submission on the draft decisions for Input Methodologies (IMs) was filed on 9 August 2010. This followed submissions made earlier this year on the IM Emerging Views and in August 2009 on the initial IM Discussion Paper. Our submissions on the DPP Issues Paper were filed on 29 April 2010 and 14 May 2010 with a cross submission filed on 31 May 2010 consistent with the Commission's consultation timetables. In addition we filed a submission on the Information Disclosure Discussion Paper on 11 September 2009.

7. The IMs are close to completion, and following consideration of the latest submissions and further consultation on the technical drafting of the determinations, will be finalised by the end of the year. There has however been no further development communicated to GDBs for either IDR or DPPs following these earlier consultations. This makes it difficult to respond to the Discussion Paper because:

- The Discussion Paper considers how starting price adjustments may be made for the DPP however no DPP exists for GDBs and the Commission has only just commenced its initial consultation on the DPP with the April 2010 Issues Paper; and

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<sup>2</sup> For example, GasNet is smaller than Nova Energy's gas business, which is exempt from the new regulatory arrangements.

- The Discussion Paper proposes a methodology which appears to rely heavily on information disclosed under IDR, however as we have submitted previously, and as the Commission has also previously recognised, the information disclosure dataset for GDBs is not as robust as it is for other sectors and may not provide information suitable for this purpose.
8. Accordingly GasNet is somewhat unclear why the Commission has issued the Discussion Paper at this time, nearly two years prior to the planned introduction of the DPP for GDBs and prior to the resolution of the other aspects of Part 4 which will provide critical inputs into the proposed methodology.
  9. For many years industry regulators have chosen to prioritise electricity distribution sector reform ahead of the gas distribution sector. The Gas Information Disclosure Regulations 1997 which continue to apply to GDBs are a prime example of this behaviour. Since 1997, IDR applying to EDBs has been modified significantly twice (in 1999 and 2008) with other incremental, but notable, amendments at other times (such as a new Asset Valuation Handbook in 2004). Although amendments to components of gas sector IDR have been drafted (in 2000 and 2002), they have never been implemented.
  10. The Discussion Paper appears to be primarily targeted at the EDB DPP which is already in place. We understand the Commission is considering making potential changes to starting prices within the EDB DPP next year. The analysis presented in the Discussion Paper uses EDB information. Although there is recognition of the differences between GDB and EDB data<sup>3</sup> the Discussion Paper includes no information about how the Commission intends to apply its proposed methodology to GDBs given these data limitations.
  11. Accordingly we are concerned that the consultation on the regulatory provisions of Part 4 for GDBs is starting to exhibit some of the characteristics of previous regimes where the electricity sector dominates the consultation process. This has the potential for the consultation process for GDBs to be less comprehensive than it otherwise might be and for the resulting regulatory decisions to fail to fully reflect the circumstances relevant to the gas sector.
  12. We therefore request that the Commission suspend its consultation on starting price adjustments for the DPP to apply to GDBs at this time and:

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<sup>3</sup> Refer Discussion Paper, paragraphs 4.17, 4.19, 6.1 and 6.21

- Complete the IMs;
- Review previous submissions on IDR and develop, consult on and implement revised IDR for the GDB sector, consistent with the IMs;
- Review the submissions on the DPP Issues Paper for GPBs and progress the development of the DPP including further consideration of:
  - Information requirements;
  - Timing;
  - Regulatory provisions (such as Section 55F(2));
  - How to implement the IMs into the DPP;
  - Transition to the DPP (including consideration of the potential differences for those subject to gas authorisations to those which are not); and
  - How to set starting prices.

13. Notwithstanding our request for the Commission to suspend its consultation on starting price adjustments for GDBs, we offer some preliminary comments on the proposed approach below.

### **Legislative Requirements**

14. Part 4 of the Commerce Act requires the Commission to reset starting prices at the beginning of the regulatory period as follows (Section 53P):

*(3) The starting prices must be either –*

- a) *the prices that applied at the end of the preceding regulatory period; or*
- b) *prices, determined by the Commission, that are based on the current and projected profitability of each supplier.*

*(4) Starting prices set in accordance with subsection (3)(b) must not seek to recover any excessive profits made during any earlier period.*

15. The Discussion Paper's proposal is that starting prices will be set in accordance with Section 53P(3)(b). There is no discussion as to why this is the case, and in

particular what considerations the Commission has made in choosing 53P(3)(b) over 53P(3)(a).

16. In addition the Discussion Paper does not consider the relevance of Section 55F(2) which provides for the Commission to modify prices for GDBs prior to the implementation of the DPP. This would appear to be directly relevant to the choices available to the Commission under 53P(3) as the Commission has the ability to require GDBs to lower prices in response to the rate of change in prices charged for regulated services between 1 January 2008 and the date of the initial DPP determination. Indeed the DPP Issues Paper suggests that the Commission considers it would be advantageous to avoid multiple price adjustments and any price adjustments to be made under Section 55F(2) would most likely be introduced as part of the starting price adjustments for the initial DPP.<sup>4</sup>
17. It is not clear why this proposal has not been further developed in the Discussion Paper. As there is no equivalent for Section 55F(2) for EDBs perhaps its omission reflects our perception that the primary purpose for the Discussion Paper is to set starting prices for the EDB DPP.
18. We therefore submit that the Commission must adequately consult on the options available to it in determining how starting prices should be established for the DPP to apply to GDBs. This must include full consideration of Sections 53P(3) (a) and (b) and 53P(4), and in addition Section 55F(2). We do not believe the Discussion Paper adequately considers these options.

### **Assessing Current and Projected Profitability**

19. In advocating the approach permitted by Section 53P(3)(b), the Discussion Paper proposes a methodology which involves assessing regulatory profit (using a Return on Investment (ROI) measure which currently exists in EDB disclosures) against an industry wide band which is to be centred on a weighted average cost of capital (WACC) point estimate. The illustrative worked example, which uses EDB data, is based on 2008/09 information, which the Commission notes will be updated for the final starting price adjustments for EDBs. There is no corresponding example or explanation for GDBs. However, we believe provision of illustrative worked examples for the three ROI points found in figure 3.1 representing suppliers A to C

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<sup>4</sup> Commerce Commission, Initial Default Price-Quality Path for Gas Pipeline Businesses, Issues Paper, 12 April 2010, paragraph 5.5

would have been more appropriate. Taking this approach may have removed some of the simplifying assumptions required in the provided worked example.

20. It is not clear from the Discussion Paper how the information will be updated. We can infer (from paragraph 4.4) that the Commission intends to use the ROI data for the 'latest year' however it is not clear how the 'latest year' is to be defined, and how this meets the requirements of Section 53P(3)(b) for 'current' profitability. We may also possibly infer that the Commission intends to consider ROI data for more than one historical year to determine current profitability (for example paragraphs 4.4 - 4.5 discuss possible normalisation adjustments for year on year variation in ROI statistics and paragraph 4.19 discusses the appropriateness of actual ROIs from any given year).
21. In addition we note that Section 53P(4) (set out above) restricts the Commission from seeking to recover any excessive profits made during an earlier period when applying Section 53P(3)(b). It is not clear to us, and the Discussion Paper does not address, how the Commission's proposed use of historical ROI data in assessing current and projected profitability is consistent with the requirements of Section 53P(4).
22. We note that the Discussion Paper includes information as to the Commission's proposals for assessing projected profitability. It is proposed that this is to be assessed using historical ROI data, to estimate possible variances in ROIs for the future DPP period, in order to determine the ROI band. The Commission's current proposal is to examine historical opex trends in order to establish this. On face value this appears to be flawed because:
- GDBs do not have a historical ROI dataset;
  - Historical measures of regulatory profit are unlikely to be consistent with the IMs;
  - Opex is only one component of an ROI measure and not the only component which exhibits year on year variability; and
  - Future events are to be ignored when assessing projected profitability.
23. As the Discussion Paper does not include any explicit discussion of these issues for GDBs we are unable to provide further comment in response at this stage. As suggested above, we submit that the Commission suspend its consultation on

starting price adjustments for GDBs and implement the other components of the regulatory framework which are to apply to GDBs. These are required before the DPP starting prices can be determined in a meaningful way, and consistent with the regulatory provisions for them.

### **Upper and Lower ROI Band Limit**

24. Figure 3.1 in the Discussion Paper sets out the proposed starting price adjustment process, and demonstrates the likely impact on suppliers which have ROI measures which fall above, within or below the proposed ROI band. The Commission proposes that the ROI band is to be set symmetrically around an industry wide WACC point estimate which is to be set at the 75<sup>th</sup> percentile of the vanilla WACC range established by the cost of capital IM.
25. Paragraph 4.8 states that the WACC is the minimum rate of return that is necessary to attract debt and equity to an investment, and the expected rate of return on alternative investments of equal risk. Paragraph 4.9 indicates that it provides a measure of the return on capital required to compensate suppliers for the systematic risk in providing regulated services.
26. The use of the 75<sup>th</sup> percentile is consistent with the Commission's draft cost of capital IM. This is explained at paragraph 4.13 which indicates that the Commission considers it appropriate to err on the side of caution when estimating a WACC point estimate. Paragraph 4.16 also addresses this issue and indicates that there are uncertainties involved in assessing a WACC point estimate, and therefore the Commission's draft decision is that this should be set at the 75<sup>th</sup> percentile of a WACC range to reflect these uncertainties.<sup>5</sup>
27. GasNet supports this component of the cost of capital IM, and the intended application of the 75<sup>th</sup> percentile WACC estimate for the purpose of assessing starting prices for the DPP. However the proposed ROI band approach as illustrated in Figure 3.1, indicates that the Commission intends to implement starting prices for some regulated suppliers which would result in ROIs which would fall below the 75<sup>th</sup> percentile WACC. This would apply to:
- suppliers with ROI estimates which fall below the lower limit of the ROI band (as the Commission proposes that they will only be able to increase their starting prices to the lower level of the band); and

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<sup>5</sup> A more comprehensive discussion of the uncertainties in estimating WACC are included in the Commission's Draft Reasons Paper on the Cost of Capital IM, 18 June 2010

- suppliers with ROI estimates which fall between the lower limit of the ROI band and the 75<sup>th</sup> percentile as the Commission proposes that they will be unable to increase their starting prices at all).

28. We submit that this proposal is inconsistent with the Section 52A Purpose Statement in particular subparts a) and d). The Section 52A Purpose Statement for Part 4 states:

- (1) *The purpose of this Part is to promote the long-term benefit of consumers in markets referred to in section 52 by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services—*
- (a) *have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and*
  - (b) *have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and*
  - (c) *share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and*
  - (d) *are limited in their ability to extract excessive profits.*

29. By limiting regulated returns below those required to achieve the WACC estimate consistent with the cost of capital IM, the Commission is preventing suppliers from having sufficient incentives to invest in the assets required to provide regulated services and thus is acting contrary to subpart (a) of Section 52A.

30. In addition subpart (d) requires the Commission to ensure that suppliers are limited in their ability to extract excessive profits. The proposal will result in suppliers being limited in their ability to earn normal profits. Again we submit this is inconsistent with the Section 52A purpose statement.

31. Accordingly we do not support the proposal for suppliers with ROIs which fall below the WACC point estimate to be prevented, via the DPP, from increasing prices (should they choose to do so) to that level.

32. We also note that the upper (and lower) ROI band is proposed to sit above (and below) the 75<sup>th</sup> percentile WACC to allow for variability in ROI. Thus suppliers with ROIs above the upper band will be required to adjust their prices to the top of the band. Any supplier between the WACC estimate and below the upper ROI band will not be able to achieve the same level of returns as those reset down to the

upper limit of the band. We submit that this is inequitable and all suppliers should have the opportunity to achieve the same level of returns as those to be provided to businesses which currently report profits above the upper ROI band. The variability in ROI estimates (which the band is designed to capture for the purpose of assessing current and projected profitability) is to be established from industry wide (not business specific) data and therefore the resulting band should apply to all industry participants. This is consistent with the intended industry wide nature of the DPP.

If you have any queries in relation to this submission, please contact me.

Yours sincerely

A handwritten signature in black ink, appearing to be 'Geoff Evans', written in a cursive style. The signature is contained within a faint rectangular border.

**Geoff Evans**  
General Manager