

19 December 2011

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[By email]

Dear Mark

Submission on Initial Default Price-Quality Paths for Gas Pipeline Businesses, Draft Reasons Paper

1. The Commerce Commission (Commission) has released a Draft Reasons Paper “Initial Default Price-Quality Paths for Gas Pipeline Businesses”, dated 21 November 2011 (the Draft Reasons Paper). This follows earlier consultation papers on the proposed Default Price-Quality Path (DPP) for Gas Pipeline Businesses (GPBs):
 - The April 2010 Issues Paper on the Initial DPP for GPBs;
 - The August 2010 Discussion Paper on Starting Price Adjustments for DPPs;
 - The April 2011 Discussion Paper on the Initial DPP for GPBs; and
 - The August 2011 Discussion Paper on Setting of Starting Prices for GPBs under the Initial DPP.
2. GasNet welcomes this further opportunity to engage with the Commission on the setting of the Initial DPP. This submission reflects the views of GasNet on the most critical aspects of the Draft Reasons Paper that are of relevance to our business.
3. 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 386 kilometres long, with approximately 10,300 connected consumers.

4. GasNet is small in the context of the gas distribution sector, particularly relative to the other two much larger Gas Distribution Businesses (GDBs). WGL and its predecessors have been responsible for the delivery of gas in the Wanganui and surrounding districts for many years and over those years have established and maintained excellent relationships with the gas consumers connected to our network and the retailers which service them. We have previously submitted that our overarching concern regarding the development of the regulatory regime for GDBs is that the Commission develops regulation that is suited to all GDBs, in particular in recognition that our network is the smallest GDB captured by these requirements.
5. The Draft Reasons Paper has however generated a more fundamental concern about the credibility of the regulatory regime which is now proposed. In particular we have serious concerns about the potential harm that the regime may impose on GasNet, and importantly the excellent relationships we have with retailers and local consumers. As gas is a discretionary energy source, market perception, in particular in relation to prices, is crucial. This is a critical differentiator to electricity. This feature of the gas market appears to have been totally ignored in the Draft Reasons Paper.
6. We outline our key submission points below. Our comments are limited to those relevant for GDBs.

Setting Starting Prices

7. It is proposed that initial prices for the DPP will be set by rolling over prices from the previous regulatory period. This Draft Decision has been formed after consideration of section 53P(3) of Part 4 of the Commerce Act (the Act) which requires starting prices to be set either on the basis of:
 - a) prices that applied at the end of the preceding regulatory period; or
 - b) prices, determine by the Commission, based on current and projected profitability of each supplier.
8. In its earlier consultation papers (listed in paragraph 1. above), the Commission indicated a preference for option b) and went so far as to consult on a possible

method for determining current and projected profitability. In parallel, the Commission also consulted on a similar approach for resetting starting prices for the DPP applying to Electricity Distribution Businesses (EDBs).

9. However on 26 September 2011, the High Court ruled that input methodologies (IMs) must be developed to specify how starting prices should be set under section 53P(3)(b) for the DPPs applying to EDBs and GPBs. Thus before the Commission can develop its starting prices using the section 53P(3)(b) approach it must consult on and develop appropriate input methodologies. The Commission's recent Process and Issues Paper¹ includes a proposed timetable for GDBs as follows:

- Consultation on IMs: January 2012 – September 2012
- Initial GDB DPPs: Commences 1 July 2012
- IM Determinations: September 2012
- Consultation on whether to reset GDB DPPs: Post 2012
- Possible reset of GDB DPPs: 1 October 2013.

10. Accordingly the Commission's Draft Decision is that the Initial DPP will be set using section 53P(3)(a) as at 1 July 2012. Following consultation, the Initial DPP may be reset using section 53P(3)(b). The indicative timing for the reset is 1 October 2013.

11. The Draft Decision is that starting prices for the Initial DPP for GDBs as at 1 July 2012 will be:

- For controlled GDBs, the relevant prices at the expiry of the Gas Authorisations, ie: 1 July 2012;
- For uncontrolled GDBs, including GasNet, the prices at the end of the preceding regulatory period. The Commission has interpreted this as prices as at 30 June 2010 with no adjustments for CPI.

12. The impact of this Draft Decision on GasNet is that weighted average prices at 1 July 2012 will need to reduce by approximately 7% to match the 30 June 2010 prices. We note the proposal that the price reduction is implemented on 1 October

¹ Commerce Commission, Additional Input Methodologies for Default Price-Quality Paths, Process and Issues Paper, 9 December 2011

2012 for the 12 month pricing period, but calculated to be equivalent to 15 months of revenue reduction, ie: from 1 July 2012.

Unfortunate Consequence

13. The Draft Reasons Paper presents this outcome for the uncontrolled GDBs as an 'unfortunate consequence' of the Commission not being able to use section 53P(3)(b). We understand the High Court ruling is a consequence of deficiencies in the Commission's proposed methodology for resetting starting prices for EDBs. The unfortunate impact of this however is a Draft Decision which is unreasonable, inequitable for the uncontrolled GDBs and clearly inconsistent with the intention of Part 4. Accordingly identified deficiencies in the Commission's regulatory decision making are to result in penalties for regulated GDBs. GasNet submits this is contrary to the principles of natural justice.

14. GasNet has not engaged formal legal advice on the Commission's interpretation of Part 4, however we have sighted Vector's draft legal analysis and fully support its recommendations and conclusions. In particular we believe that the Draft Decision represents an interpretation of the legislation which is inconsistent with the Part 4 Purpose Statement. The Purpose of Part 4, set out in section 52A, is intended to promote outcomes that are consistent with those produced in competitive markets, such that suppliers have incentives to:

- Innovate and invest;
- Improve efficiency;
- Provide services at a quality that reflects consumer demands;
- Share benefits of efficiency gains with consumers; and
- Are limited in their ability to extract excessive profits.

15. The Draft Decision does not demonstrate how the proposed reduction in prices to the levels that were originally implemented on 1 October 2009 is in any way consistent with the Purpose Statement. In our view the Draft Decision is contrary to the objectives of the Purpose Statement because it introduces instability and uncertainty into the regulatory regime which hinders investment, innovation and hence efficiency gains. It is also contrary to the behaviour of competitive markets. As noted above, gas is but one fuel source in a highly competitive market. Pricing instability has the potential to disrupt use of this discretionary fuel in the market and suppress demand. It is not plausible that retailers and consumers should be

subjected to price reductions now, with the likelihood of higher price increases in the future to compensate for the short term reductions, without market consequences.

Inconsistent with CPI Allowance

16. In addition, the Draft Decision ignores the intent of section 55F(2) which is clearly to allow prices to match CPI movements until new methodologies are determined and prices able to be reset. In its previous consultations on section 55F(2), the Commission never once indicated that the CPI allowance, which suppliers have been able to incorporate into their pricing decisions from 1 January 2008, consistent with Part 4, would need to be reversed in future periods.

Consequences Not Articulated in Previous Consultations

17. In addition we note that in previous consultations on setting starting prices, the Commission has not articulated this interpretation of section 53P(3)(a) for uncontrolled GDBs. We have searched through all previous consultation papers and despite the extensive consultations on setting starting prices we can find no reference to this interpretation, ie: that prices would need to roll back to reduce starting prices to 2010 levels if section 53P(3)(a) were applied. Specifically:

- The April 2010 Issues Paper considered assessment of compliance with the CPI Criterion (ie: section 55F(2)) which was to continue through to the end of the pricing period commencing 1 October 2012;²
- The same paper considered claw back in respect of compliance with section 55F(2) for the starting price assessment without reference to potential price reductions (in fact it only discusses price increases);³
- The August 2010 Discussion Paper sets out the options under section 53P(3), but only addresses a possible approach to section 53P(b) with no consideration of the alternative approach section 53P(a) or what that would mean in practice;⁴

² Commerce Commission, Initial Default Price-Quality Path for Gas Pipeline Businesses, Issues Paper, 12 April 2010, paragraph 5.8

³ Ibid, paragraph 5.18

⁴ Commerce Commission, Starting Price Adjustments for Default Price-Quality Paths, Discussion Paper, 5 August 2010, paragraphs X.1, and X.2

- The April 2011 Discussion Paper addresses the CPI Criterion again without any reference to the possibility of prices having to be reduced to back out the CPI allowance from 30 June 2010;⁵
- The same paper considers the options for setting starting prices under section 53P(2) and confirms the intention to use section 53P(3)(b) without a discussion of the alternative. The justification is that it must use section 53P(3)(b) ‘*as no regulatory regime is currently in place for some GPBs*’;⁶
- The August 2011 Discussion Paper once again set out the section 53P(3) options for setting starting prices and expressed the preference for using option (b) on the basis that it is more consistent with the Purpose Statement. No mention of the alternative (a) and potential for CPI roll back was made.⁷

18. We can only conclude that it was not until this recent Draft Reasons Paper that the Commission contemplated that the options available under section 53P(3) included roll back to 2010 prices for uncontrolled GDBs. It is not clear to us why this outcome has now been proposed and to what extent the Commission has tested its perceived statutory anomaly.

19. In our September submission we noted and supported Vector’s proposal that the Initial DPP should start with existing prices (ie; those already in place at the beginning of the Initial DPP) due to the lack of robust data available for GPBs.⁸ We also note that Vector had assumed that current prices would apply for all GPBs, should this option be applied.

Justifications Not Valid

20. The Draft Reasons Paper sets out two key justifications for setting Initial DPPs at 1 July 2012 with starting prices based on prices rolled over from previous periods. It is argued that these are based on the need to crystallise two aspects of the regime that are important to ensuring the Purpose of Part 4 is met, namely:

⁵ Commerce Commission, Initial Default Price-Quality Path for Gas Pipeline Businesses, Discussion Paper, 1 April 2011, paragraphs 5.1 – 5.27

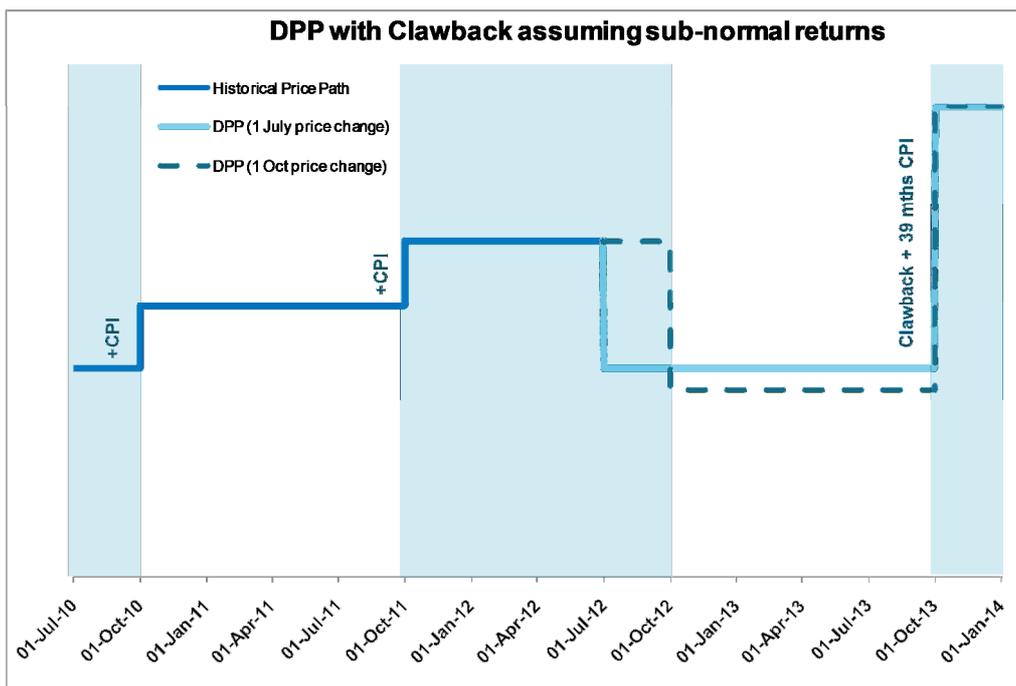
⁶ Ibid, paragraph 5.46

⁷ Commerce Commission, Setting of Starting Prices for Gas Pipeline Businesses under the Initial Default Price-Quality Path, Discussion Paper, 22 August 2011, paragraphs 2.9 – 2.13.

⁸ GasNet, Submission on Setting Starting Prices for the Initial Default Price-Quality Path for Gas Pipeline Businesses, paragraph 15

- The ability to apply claw-back if starting prices are reset; and
- The right of a regulated supplier to seek a Customised Price-Quality Path (CPP).⁹

21. We do not support these reasons and note the Draft Reasons Paper does not explain why these are consistent with promoting the Purpose of Part 4 in the context of the starting price Draft Decision. Firstly we do not accept that it is reasonable to justify a poor decision now on the basis that the Commission has the ability to use claw back at a future date as a correction mechanism. The outcomes are uncertain and the primary impact of this mechanism is that it introduces price instability. The following chart illustrates the likely impact on prices, in the event that the proposed 1 July 2012 (or 1 October 2012) price reduction is clawed back at a 1 October 2013 reset. As demonstrated the impact on consumers is highly variable, particularly given that 1 October 2011 prices are already in place.



⁹ Commerce Commission, Draft Reasons Paper, paragraph 7.14

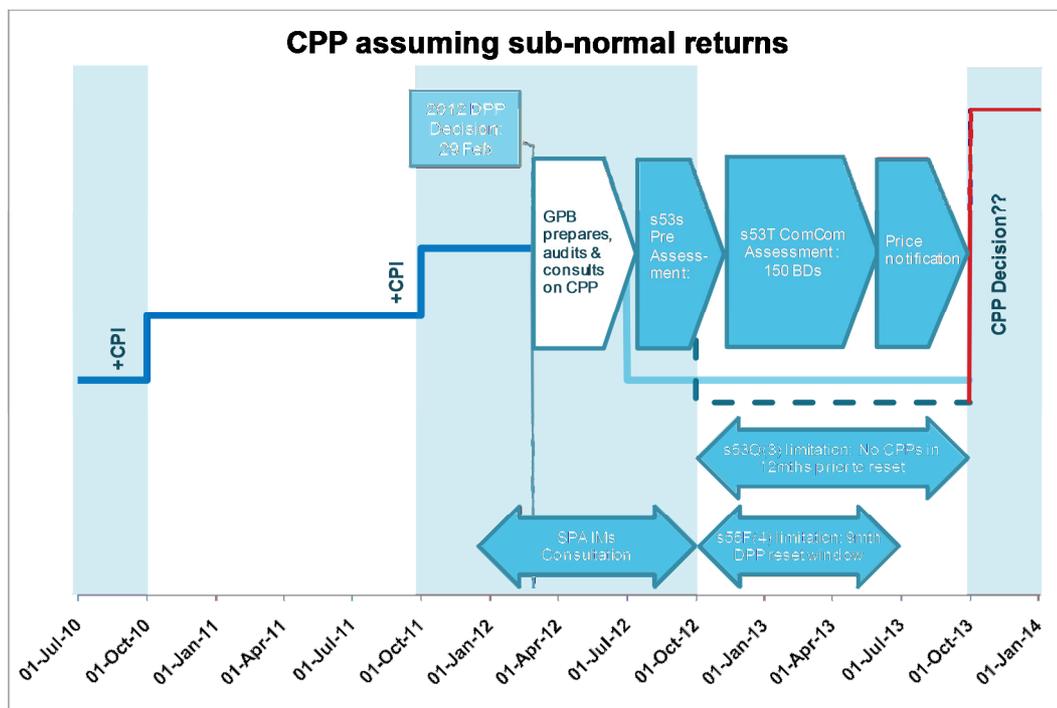
22. Secondly we interpret the Commission's desire to initiate the opportunity for CPPs as an expectation that a supplier may choose to apply for a CPP in order to either seek remedies for the reduced starting prices, or to obtain prices which better meet their investment needs.¹⁰ However, we submit that this option is severely compromised by the following circumstances:

- A supplier is restricted from applying for a CPP within 12 months of a DPP reset (section 53Q(3)) which suggests any CPP application window prior to the reset will be limited to the 3 months commencing 1 July 2012. As the Determination will not be made until the end of February, there is insufficient time for the CPP proposal to be prepared, independently verified, audited and submitted;
- The earliest any pricing remedy is available under a CPP will be for the pricing period commencing 1 October 2013 (given the CPP assessment and approval process), which is exactly the same time as the proposed DPP reset;
- A supplier will not know the DPP that will apply to it from 1 October 2013, and thus will not know the counterfactual. This will prevent it from assessing whether or not a CPP is required. As the 1 October 2013 reset may include claw back for the period commencing 1 July 2012, it is also not possible to quantify the counterfactual from the beginning of the Initial DPP;
- As supplier is only able to make one CPP application within a regulatory period, it is unlikely any applications will be made before the reset, given the uncertainty that exists; and
- A supplier is unable to recover its costs incurred in making a CPP application, other than audit, verification, application, and the Commission's fees which are associated with a successful proposal.

23. Accordingly we do not believe that the CPP is a real option for GDBs before the proposed reset in October 2013. Even if a reset is not implemented, it is the uncertainty regarding the potential for a reset which prevents GDBs from investing in a CPP proposal prior to that date. In addition, a CPP is not useful for seeking remedy for the proposed price reduction at 1 July 2012, as it can achieve no more than the proposed claw back option discussed above. This is illustrated in the chart overleaf which shows that remedies for the 1 July 2012 price reduction under a CPP are available at exactly the same time as the claw back illustrated above.

¹⁰ Supra n7, paragraph 2.11

24. In any event, as previously submitted, GasNet does not view a CPP as a viable option for a business of our size. Therefore the availability of a CPP offers us no relief to the Draft Decision.



Recommendation

25. Accordingly, for the reasons set out above GasNet does not support the proposed approach to setting initial prices under the DPP. Our submission is that the implementation of the Initial DPP for GDBs is deferred until the Input Methodology and reset decisions have been made. We believe this is a valid option because:

- The CPI Criterion set out in section 55F(2) will still apply;
- Whilst section 55E requires a DPP determination to be made ‘as soon as practicable’, there is no time limit imposed on this. We submit that the alternative is not practicable because it results in outcomes which are unreasonable and inequitable for uncontrolled GDBs, disruptive for retailers and consumers and may be reversed within 15 months;
- It is consistent with the Commission’s previously stated view that it was not practicable to use 53P(3)(a) as no regulatory regime is currently in place for uncontrolled GPBs;

- It is consistent with the intent of section 53P(11) which allows for roll over of existing prices and rates of change if a section 52P determination has not been made by the end of the regulatory period; and
- Deferral of the quality standards can be accepted, as these involve regulatory monitoring (ie: there is no proposed regulatory intervention in the service quality of GDBs at 1 July 2012) and monitoring can be incorporated into the revised information disclosure regime which is to apply from that date.

26. We note the Control Authorisations expire on 1 July 2012. We also note the precedent where the previous regulatory (threshold) arrangements for EDBs were rolled forward for one year after the expiry of the threshold period to allow sufficient time for the DPP to be determined. In addition, we understand that the section 55F(2) criterion could be applied to controlled GDBs without detrimental impact on their price paths, as their price paths have been consistent with CPI since January 2008. We believe these options could be considered as viable solutions for managing the transition period between the authorisations and a deferred DPP for the controlled businesses.

27. As an alternative, we submit that if the Commission insists on implementing a DPP at 1 July 2012, then current prices should be used as starting prices, to avoid the disruption, inequity and confusion that is associated with the Draft Decision for uncontrolled businesses.

Quality Standard

28. It is proposed that the Quality Standard will be set for all GDBs as a 'Response Time to Emergencies' standard which is to be specified in two tiers:

- 80% of responses to be made within 60 minutes; and
- 100% of responses to be made within 180 minutes.

29. GasNet supports this proposal. Table 4.1 of the Draft Reasons Paper sets out the proposed definitions of 'Emergency' and 'Response Time'. We believe these are inadequate and require further refinement. Specifically:

‘Emergency’ means:

- An incident on the network (excluding GMS), for which one of the emergency services (i.e. fire service, ambulance, police) is called and subsequently directs the GPB to attend; or
- An unplanned incident on the network (excluding GMS), that disrupts the supply of gas to more than five consumers concurrently; or
- An incident on the network (excluding GMS), which results in the escape or ignition of gas and the need to evacuate one or more premises.

‘Response Time’ means:

The time elapsed from when an emergency is first reported to a GPB representative until a GPB’s representative arrives at the location of the emergency.

30. Table 4.1 of the Draft Reasons Paper also sets out the proposed Standards to be met. Again, we believe these require further refinement. Specifically:

Standard to be met:

- 80% of Emergencies to have Response Times no greater than 60 minutes (applicable to GDBs only)
- 100% of Emergencies to have Response Times to be no greater than 180 minutes (applicable to GTBs and GDBs)

31. In addition, we are highly concerned at the inference in paragraph 4.28 of the Draft Reasons Paper that gas suppliers may have a reduced incentive to respond to an emergency in a timely manner without including an upper limit to the quality standard. This demonstrates a disturbing misunderstanding of the characteristics of gas supply networks and the potentially hazardous nature of the product transported. It is inconceivable that a GDB would intentionally delay responding to an emergency event which involves emergency services, building evacuation or an event affecting more than 5 consumers (or any consumer). We encourage the Commission to deepen its understanding of our business so that such misconceptions can be eliminated from its regulatory decision making.

Other Matters

32. We note the proposed definition of the ‘gas distribution network’ as set out in paragraph 3.8 of the Draft Reasons Paper. The proposal to define the termination

as the outlet of the Gas Measurement System (GMS) but excluding the GMS itself is not reasonable. Industry practice is to define the termination as up to the inlet of the GMS. We submit the definition used in the DPP should be consistent with this.

33. GasNet supports the following aspects of the Draft Reasons Paper:

- Non-integrated price quality paths, with further investigation into the possibility of integrating these sometime in the future;
- No regional disaggregation for the quality standards;
- A weighted average price cap for GDBs;
- Claw back under section 55F(2) should not be applied;
- Assessment periods should align with pricing periods; and
- An X factor of 0.

34. We have not considered the proposed compliance formula, consistent with our submission to defer the implementation of the DPP until IMs have been determined. Our initial assessment of the proposed *ex ante* compliance approach for the price path and *ex post* compliance approach for the quality standard is that it:

- Introduces unnecessary complexity into the price path assessment compliance formula; and
- Creates a disjoint between the timing of the price and quality assessments which is unhelpful for interested persons such as shareholders and consumers.

35. Accordingly we submit that both components of the DPP should be assessed on an *ex post* basis.

36. We note references to information disclosure information throughout the Draft Reasons Paper, and how this information may be used to inform future DPP decisions. We note that information disclosure is most likely to apply at each financial (ie: June) year end, whereas we understand it is intended that future DPP resets will use pricing (or September) year ends. The Draft Reasons Paper does not consider how this disjoint will be overcome.

Closing Remarks

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 over a light grey rectangular background.

Geoff Evans

General Manager