

27 May 2011

GasNet Limited
8 Cooks Street
PO Box 7149
Wanganui 4541

Dr Mark Berry
Chair
Commerce Commission
P O Box 2351
Wellington

Telephone; (06) 349 2050
Fax; (06) 349 0135
www.gasnet.co.nz

[By email]

Dear Mark

Submission on Initial Default Price-Quality Path for Gas Pipeline Businesses

1. In April 2010 the Commerce Commission (the Commission) released its Issues Paper on the Initial Default Price-Quality Path (Initial DPP) for Gas Pipeline Businesses (GPB). The Commission has since released a further Discussion Paper on the "Initial Default Price-Quality Path for Gas Pipeline Businesses" (the Discussion Paper) on 1 April 2011. This Discussion Paper presents the Commission's latest views, taking into account industry submissions.
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 aspects of the Discussion 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 366 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). Our overarching concern in this regard is that the Commission develops regulation that is suited to all regulated GDBs. In particular, it is our concern that DPPs are not overly burdensome or inflexible on GasNet, which is the smallest supplier captured by these requirements.

5. We outline our key submission points below. To the extent possible we have grouped these into similar topic headings to that used in the Discussion Paper.

Nature and Scope of Determination

6. GasNet reiterates our support for the Commission's view that Gas Transmission Business (GTB) and GDB services should be treated discretely for the purposes of DPP regulations. Merging the two into one DPP would make it more difficult for the Commission to target service specific issues and would increase the likelihood of regulatory complexity or unnecessary regulations being imposed on individual suppliers.

Differentiation between GTBs and GDBs

7. The Commission's current view is that gas distribution and transmission services are suitably defined in both the Commerce Act 1986 (the Act) and the IMs that apply to them and any further differentiation is not required.
8. The two relevant issues for GasNet relate to where the gas distribution network starts at the transmission boundary and where it ends at the consumer boundary. Our primary concern is that the IMs do not appropriately define the distribution boundary with the consumer.
9. The IMs define the boundaries of the distribution network as the "delivery point from the *transmission network*" and "the *point of supply*" at the consumer end. The Commission in turn refers to regulation 5 of the 'Gas (Safety and Measurement) regulations 2010' (*the Gas Regulations*) to define the *point of supply*.
10. GasNet is comfortable that the IM definition of the transmission network, as laid out in 3.12 of the Discussion Paper, is sufficient to define the boundary between the transmission and distribution networks.
11. However, the Commission's reliance on the Gas Regulations to define the *point of supply* raises a number of issues. Under s55 of the Commerce Act 1986 (the Act), meters are excluded from the definition of *pipeline* services. However, by contrast, the Gas Act describes the end of the *distribution system* as the *point of supply*,

which typically is the 'Gas Measurement System (GMS) outlet' and which includes the GMS.¹ Therefore under the Gas Regulations meters would be included, which is inconsistent with the Act. To further complicate matters, the *point of supply* as defined under the regulations can be varied under s5(3) of the regulations. The Commission's reliance on gas regulations to define the *point of supply*, and therefore the end of the distribution network, is therefore problematic.

12. GasNet believes that the end of the distribution network should be defined as the point where the network connects into the GMS; or the 'GMS inlet'. We believe that defining the boundary of the distribution network with reference to the 'GMS inlet' would be more consistent with the Act's definition of *pipelines*, which excludes meters.

Integrated vs. Separate Price Quality Paths

13. The Commission has reconfirmed its initial preference for separately specified and assessed price-path and quality standards for the Initial DPP. The Commission believes an integrated price-quality path may be achievable at the first reset if more robust quality data can be collected over the initial regulatory period as part of information disclosures.
14. GasNet supports these conclusions. However, we stress that the DPP needs to eventually reflect the price-quality trade off that is inherent in gas distribution prices by integrating cohesive quality standards into the price path. Suppliers must be able and incentivised to recover investments in improved quality under a DPP, where this is consistent with consumer demands, without having to resort to a customised price-quality path (CPP).

Form of Control for GDBs

15. GasNet supports the Commission's preliminary view of applying a Weighted Average Price Cap to GDBs. This will allow GDBs to adjust their prices irrespective of volume growth within an overall notional price cap.

¹ The *point of supply* defined in regulations made under the Gas Act – specifically the Gas (Safety and Measurement) Regulations 2010 – is typically the outlet of the GMS.

Claw-back

16. The Commission may apply claw-back under section 55F(2) of the Commerce Act 1986 (the Act) if a GPB increases its prices by more than CPI between 1 January 2008 and a new determination. The Commission is of the view that 'claw-back' will not be relevant to GPBs for the Initial DPP. GasNet supports the Commission's preliminary view and this rationale.
17. As a further point, applying claw-back would be unfairly retrospective and would be inconsistent with the broad Part 4 purpose statement of providing incentives to invest. In order to appropriately apply claw-back, the Commission would need to develop an approach to distinguish legitimate price changes from those that seek to recover excess profits. Such an approach would need to be broadly consistent with DPPs and Input Methodologies developed to date, both of which have not been available to GPBs to guide their pricing decisions since January 2008. It would be unfair and detrimental to investment certainty for the Commission to develop claw-back assessment criteria now, unless there existed evidence of *extreme* price increases above the CPI Criterion without justification by the supplier.
18. Indeed, the Discussion Paper has all but ruled out the need for applying claw-back to Vector, Powerco, and MDL². Since Part 4 was introduced in 2008, GasNet has been mindful of the ramifications of section 55F(2) and our price increases over the 2008 to 2011 period have not exceeded inflation in this period. For this reason GasNet concurs with the Commission that claw-back is not relevant to the Initial DPP for GasNet.

Compliance with Price Path

19. The Commission highlights in the Discussion Paper the following key points in its proposal for GDBs to demonstrate compliance with the Price Path:
- a. a similar revenue differential term to that developed for EDBs (i.e. $R_{t-1} - NR_{t-1}$) will be adopted:

² Discussion Paper, Paragraph 5.24-5.25

- b. Historical quantities from two years prior to the current period will be used for the purposes of determining ANRt and NRt.
- 20. GasNet supports the Commission's proposal for compliance with the Price Path. In particular,:
 - a. The revenue differential term will allow for forecasting errors to be accounted for by allowing for 'unders' and 'overs'; and
 - b. Use of historical quantities from two periods prior will provide certainty and remove compliance costs associated with the reconciliation of estimated and actual quantities under a t-1 approach.

Catering for future needs

- 21. The Commission's view is that suppliers have sufficient flexibility in the DPP or through applying for a CPP to accommodate most suppliers' operating and investment needs.
- 22. As a general point on this topic, GasNet believes DPPs should be flexible enough to accommodate all normal investment and operational circumstances, as well as any moderate market developments (e.g. input price inflation or the potential impact of the Emissions Trading Scheme), without having to apply for a CPP. This principle of flexibility should also extend to accommodating the reasonable needs of both small and large suppliers.

X Factor and TFP

- 23. The Commission proposes to set an X-factor of zero for the Initial DPP. This current view is based upon advice from Economic Insights which concluded that there was no strong evidence to suggest that GPB TFP or input-price growth is different to that experienced by the wider New Zealand economy. Based on this, Economic Insights recommended an X factor of zero be adopted, which the Commission accepted.
- 24. GasNet supports the Commission's proposal to set X to zero. Amongst other things, this will ensure consistency with the X factor applied to EDBs, which seems sensible given gas distribution's parallels with this sector. Furthermore, as the two

largest GDBs also manage large EDBs they are unlikely to have materially different TFP differentials to that of their EDB peers.

25. Despite our support for a zero X factor, GasNet remains concerned over the Commission's reliance on a cursory TFP analysis in forming its views on an appropriate X factor for GPBs, given the clear lack of robust productivity data and the outstanding model specification issues. While having not had the opportunity to assess Economic Insights' work in detail we, nevertheless, do not support TFP analysis in setting X factors at this time, until this analysis can be based on more robust data and until known specification issues are resolved.
26. GasNet is encouraged by the Commission's desire to develop a new data-set of GPB input and output data as part of information disclosures to resolve one of these problems, and we would welcome further industry dialogue on scoping and development of data capture to ensure these disclosures are targeted and least cost.
27. We do not believe, however, it is efficient to invest resources into developing a detailed and robust TFP model at this time. Realistically, it will be some years before a GPB productivity data-set of sufficient longevity and quality is available to undertake a detailed TFP study³. The Commission should therefore concentrate on scoping and developing a robust set of productivity data.
28. To this end, we note the Commission has presented in Appendix A of the Discussion Paper a list of variables required to support TFP analysis across the Australian gas sector. The Commission believe most, if not all, of these requirements may be useful in the New Zealand context. GasNet is concerned by the implied application of this data for several reasons:
 - a. This data should not be discussed for the purposes of DPPs in isolation of the wider debate on Information Disclosures. There are likely to be several uses for the information outlined in Appendix A and it would make sense for the Commission to present and discuss a cohesive list of information that it believes is necessary to support both DPPs and Input Methodologies.

³ With deliberations on the next DPP reset only some 4 years away, we believe it is unlikely that such a data-set could be in place prior to the next reset.

- b. Many of the valuation variables outlined in Appendix A are no longer required under input methodologies so to include them would be counter-productive and extremely costly (i.e. DORC, ORC). The inclusion of only those gas assets applicable to the New Zealand context would also need to be addressed in adopting these variables.
- c. The level of specificity is extremely detailed in some cases. It would be unlikely that this level of detail would be useful or material in determining productivity for the industry relative to slightly more aggregated data (i.e. the proposed breakdown of operating and maintenance costs appears excessive, for example 'maintenance on cathodic protection'). The cost of recording, storing and reporting such detail needs to be weighed against the usefulness of this data in assessing productivity.
- d. System Physical Data variables would need to be aligned with New Zealand GPBs usage of these assets.

Quality Standards

29. The Commission has proposed to adopt a measure of gas safety as the sole quality standard for the GDB DPP. Under the proposed 'Emergency Response Times' standard, suppliers must respond to 95% of emergencies within 60 minutes⁴. The Commission additionally outlines a number of other measures which GDBs must report on.

30. It is unclear from our reading of paragraph 7.29 whether the additional reporting measures outlined in table 7.1 to 7.3 of the Discussion Paper are to be part of the Initial DPP decision or are to be dealt with separately in information disclosures (i.e. they are only being discussed in the Discussion Paper for completeness). These additional measures, while good to discuss in the context of whether to apply them as a standard to the DPP, should be more fully addressed in the information disclosures consultation and only the standards should be included in the Initial DPP determination.

31. GasNet agrees that only one or two quality standards should be applied to DPPs, especially for the initial DPP, to avoid regulatory complexity. The more standards

⁴ Although we note in Table 7.1 of the Discussion Paper that the Commission is still to determine if SAIDI and SAIFI will be applied as standards under the DPP.

that are introduced the more difficult it will be for the Commission to assess and enforce performance against quality standards and the more difficult it will be for suppliers to target quality issues.

32. We anticipate the Commission and industry will be in a better position to define appropriate quality standards at the next DPP reset when a more robust set of quality data can be assessed. In this context, defining a gas standard for GPBs is problematic. But if the Commission does choose to adopt a standard for the Initial DPP then GasNet, on consideration of the proposed measures outlined in the Discussion Paper, believes SAIDI and SAIFI are appropriate.
33. With regards to the Commission's current position to adopt a gas safety standard, we note that the industry will have to track and monitor similar safety measures resulting from changes to the Gas (Safety and Measurement) Regulations 2010. The gas industry also has developed a clear understanding of what a gas safety emergency constitutes through reporting to GANZ and Energy Safety (part of the MED). Any safety standards set under the DPP should seek to be consistent with these regulations and standards to avoid costly rework or duplication.
34. We are also potentially concerned that the Emergency Response Times standard, as currently defined, could be problematic for GasNet to consistently comply with given the low frequency of events. Where quality standards relate to activities of low frequency, it can be easier to breach these standards when these events occur. Emergency Response Times are low frequency events for GasNet, at least as the Commission describe them. That is, while we have many public reported emergency's throughout the year - many of which do not end up having gas present - very few result in the emergency services being called out. We believe the standard should also be based on the individual GDBs geography and circumstances to reflect distances and travelling times from major response centres.
35. The problem relating to low frequency events of this nature will also only be magnified if these measures have to be reported on a regional basis. The Commission should consider whether regional disclosures are necessary in the case of such low-frequency data, in order to avoid unnecessary breaches of the quality standards.

36. As a general point, we anticipate that it will be difficult for the Commission to compare performance between GasNet and the larger GDBs due to our smaller scale. We would be more comfortable with standards set against our own (historical trend) performance than by comparison to others. To this end, the Commission should focus on monitoring individual supplier performance and trends rather than relying on these measures for comparative purposes.

DPP Assessment Period

37. The Commission has proposed two options for the assessment period:

- a. an initial one off assessment period from 2 July 2012 to 30 September 2012 followed by ongoing annual assessment periods from 1 October to 30 September; or
- b. an annual assessment period from 2 July to 1 July.

38. The Commission has expressed a preference for a) as it believes that aligning the assessment periods with pricing years will be less complex from a compliance perspective.

39. GasNet does not support aligning the assessment period with pricing years and therefore support either option. Our preference is for a 1 July to 30 June assessment period with freedom to choose pricing years. This best aligns with our current financial year and preference for a 1 October pricing reset. This also appears consistent with Powerco's and MDL's preferred assessment period too.

40. GasNet's two key concerns with the Commission's approach are:

- a. *The regulatory simplicity gained from aligning regulatory assessment and pricing years is overstated:* The Commission argue for aligning pricing years and assessment periods otherwise compliance assessments would prove unnecessarily complex as two sets of prices would need to be submitted across the assessment period. This appears to be grounds for the Commission's preference for October to September assessment periods, in order to align with most GPB's pricing years.

While GasNet is generally supportive of regulatory simplicity, the Commission's reasoning does not account for the complexity GPBs face in reconciling different financial and regulatory year ends for information

disclosures or building blocks analysis. Many GPBs, like GasNet, have a June year end and would incur significant costs in setting up financial systems and processes to produce two distinct year end results, for financial (30 June year end) and assessment (proposed 30 September year end) purposes. These accounting and systems costs would likely outweigh the additional regulatory compliance costs associated with split year pricing.

Indeed, we are aware of a number EDBs who have applied split year pricing (for all or some of the customer base) and they appear to have had little trouble in complying with price path compliance under the old Part 4a. Transpower also sets prices in April but has a June compliance period. So long as Notional Revenue falls below Allowable Notional Revenue in the assessment period then it should be up to GPBs to determine their pricing year.

- b. *An enduring 2 July assessment-period start-date will create additional complexity and cost:* Ideally the Initial DPP should start at the beginning of the financial and disclosure year on 1 July 2012. While we understand the complications brought about by the Gas Authorisation ending on 1 July 2012 it is nonsensical that an overlap in the Gas Authorisation - which applies to only two out of the five regulated GPBs - should dictate the start of the assessment period going forward for all suppliers. It would make much more sense for the start of the assessment period to align with the beginning of the month and financial/disclosure year to avoid costly rework of accounting and regulatory data at month end. We therefore do not support an ongoing regulatory period starting 2 July.

41. Ideally, GasNet's preferred option would be for the Commission to re-issue the Gas Authorisation with a 30 June 2012 end date so that the Initial DPP could start on 1 July 2012. A potential alternative would be for the first assessment period to be one day short of a full year: starting 2 July 2012 to 30 June 2013. Subsequent regulatory assessment periods should be from 1 July to 30 June.

Starting Price Adjustment (SPA) Method

42. GasNet has only recently become aware that the Commission is also seeking views from GPBs on its “2010-2015 Default Price-Quality Path Starting Adjustments and Other Amendments Update Paper” (the Update Paper) relating to EDBs. We have not had sufficient time to form a view on the details of the Update Paper prior to the initial submission deadlines. We will endeavour to respond to the Commission with our views within the Cross Submission consultation timeframes.

Closing Remarks

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

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Geoff Evans', is written over a faint, light-colored rectangular stamp or watermark.

Geoff Evans

General Manager