THE COMMERCE COMMISSION'S REVISED DRAFT DECISION ON THE INITIAL DEFAULT PRICE-QUALITY PATHS FOR GAS PIPELINE SERVICES

Submission to Commerce Commission

From Contact Energy

This submission by Contact Energy Limited (**Contact**) comments on the Commerce Commission's *Revised Draft Decision on the Initial Default Price-Quality Paths for Gas Pipeline Services*, published on 24 October 2012 (**Consultation Paper**).

For any questions relating to our submission, please contact:

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ABOUT CONTACT

Contact is one of New Zealand's leading energy generators and retailers, providing electricity, natural gas and LPG to about 560,000 customers nationwide. Our power stations generate around 25 per cent of New Zealand's electricity, we are one of the country's largest wholesalers and retailers of natural gas, and we have around 47 per cent of the LPG market in New Zealand.

Contact is one of the country's largest listed companies and one of New Zealand's most widely held stocks with around 75,000 shareholders. We employ over 1,000 people throughout New Zealand, making Contact an integral part of the national economy, our diverse society and local communities.

Contact is interested in the Commerce Commission's (**Commission**) proposed decision on the default price-quality path (**DPP**) because, on average, transmission and network charges comprise up to 45% of a customer's retail gas bill. The level of those costs is a significant determinant of the delivered cost of gas to consumers. It is therefore incumbent on the Commission to ensure that:

1. The costs incurred by consumers for gas pipelines services are reasonable and do not include monopoly profits or inefficient costs;

2. That sufficient incentive exist for suppliers of gas pipeline services to improve efficiency and reduce costs and innovate.

Executive Summary

Contact:

- supports the Commission's decision to set profitability-based starting prices, instead of rolling over existing prices;

- supports imposition of quality standards and **strongly** urges the Commission to develop effective reliability standards;

- supports the capping of forecast network capital expenditure at 20%;

- is concerned that the approach taken by the Commission (in part due to the requirements of Part 4 of the Commerce Act 1986 (**Act**)) creates a material bias in favour of the suppliers of gas pipeline services and consequently higher prices prevail than would been seen in a competitive market; and

- submits that the Commission's reliance on 'low-cost techniques' for obtaining forecast information should not be at the expense of delivering on the purpose of Part 4 of the Act.

Background context

Gas transmission and distribution costs represent up to 45% of a Contact customer's total retail bill. Contact wishes to ensure that consumers are not paying excessive prices for gas transmission and distribution as a result of monopoly pricing and are not receiving a sub optimal service . Contact also considers it essential that the default price-quality path (**DPP**) has sufficient quality standards to ensure that the appropriate quality and reliability incentives are included in the regulatory settings.

As we submitted in our submission on the Commission's revised draft reset of 2010-2015 default price-quality path on electricity distribution businesses (**EDB Consultation**) we understand that there has been very little retailer or consumer representation in the processes set out in Part 4 of the Act to date. This is to be expected and follows from the design of the Act and the industry and Companies Act obligation on directors to act in the best interests of the relevant company. Unless there are changes, Contact expects that a systematic bias in favour of the suppliers of gas pipeline services will prevail. The key issues are:

- **Information asymmetry**: The suppliers of gas pipeline services have a significant information asymmetry advantage over both the retailers and the Commission when valuing assets and setting operating and capital budgets. Contact has no practical ability (and the Act, in any event, doesn't provide the mechanism) to understand and, if appropriate, challenge the budget and valuation assumptions and operating and capital expenditure decisions.

- **Information complexity**: Contact has to deal with a number of suppliers of gas pipeline services each with their own charging structures. They are complex and often don't easily translate into predictable pricing relevant to consumers without significant repackaging. Even a sophisticated, well resourced party such as Contact finds it difficult to assess the appropriateness of the charges and make comparisons to try and benchmark suppliers of gas pipeline services against each other.

- **Incentives**: The major protagonists in the broader price setting processes (including all the legal challenges) are the transmission and distributions businesses (**network companies**). Some network companies are spending many millions of dollars challenging the Commission. Given the potential revenue gains from even small changes to the Commission's recommendations or findings (or in some instances delaying the process) it makes sound business sense for network companies to invest heavily in the process. The regulated income from lines charges are an overwhelming proportion of the total income of the network companies. A diligent board and management will make considerable efforts to optimise the charges for the benefit of the network company. Prudently, that will mean that managers prepare conservative budgets which allow for unexpected events and target rates of return that allow WACC to be achieved, even if adverse events occur. Economic literature supports that managers are better rewarded for outperforming soft targets rather than underperforming harder budgets – even if the latter is a better absolute result. The Companies Act requires directors to act in the best interests of the company. It is reasonable to believe that this requires directors to take all available steps to at least achieve WACC, to conservatively value assets (in this context, value more highly) and maximise income for shareholders in the long run. When this expensive (from a consumer viewpoint) conservatism is combined with explicit biases (such as allowing WACC at the 75th percentile) there is a strong systematic bias towards the suppliers of gas pipeline services over earning.

- On the other side of the equation, individual consumers have no ability to influence the prices of gas pipeline services and the lack of engagement by retailers would suggest that they do not believe that they can materially influence the pricing outcomes. This has left the Commission alone to provide a counterweight to the network companies.

Contact supports the Commission's proposal to make adjustments based on the current and projected profitability of each supplier

Contact supports the Commission's proposal to set prices based on the current and projected profitability of each supplier. The Commission's expectation outlined in the Consultation Paper that Vector may earn $110.9m more than the projected costs of supplying its transmission services if the Commission did not adjust prices is particularly persuasive. Failure to finalise the DPP in a timely manner will result in customers overpaying whilst certain suppliers of gas pipeline services continue to earn excessive profits. As we indicated in our submission on the EDB Consultation this would be an unacceptable result and have adverse reputational consequences for the energy industry as a whole.

Striking the balance in favour of consumers

The decisions the Commission makes on default price-quality paths will have a significant impact on consumers. The intention of Part 4 of the Act is that economic regulation should deliver benefits to consumers. While the purpose statement refers to the need for incentives to invest and to improve investment, those objectives are balanced by other objectives in favour of sharing the benefit of efficiency gains with consumers and limiting the ability of suppliers to extract excessive profits. The objectives are also subject to the overall purpose of promoting the long-term interests of consumers. The Commission has recognised that a trade-off between the interests of consumers and the interests of regulated suppliers is required in the context of the statutory purpose[1]. Contact suggests that the appropriate balance is to be struck in favour of the interests of consumers.

In particular, Contact suggests that in setting the regulated price of gas pipelines services, the Commission should reflect on the economic environment that persists in the regulatory period. In the current environment, profits in markets that are competitive are generally suppressed. Contact considers it inappropriate that in this environment GPSs should continue to be able to earn what seems a relatively high regulated return, especially as the central purpose of Part 4 is to be achieved by promoting outcomes that are consistent with those produced in competitive markets.

GPS information and forecasts: will low-cost forecasting techniques ultimately lead to higher costs for consumers?

The Commission has relied on suppliers of gas pipeline services information and forecasts to determine many of the inputs to the pricing model as it believes it is "*required to adopt relatively low cost approaches when resetting default price-quality paths"*.

While the purpose of default price-quality paths is to provide a low-cost way of setting price quality paths, that specific purpose does not override the overall purpose in section 52A, that is to "*promote the long-term benefit of consumers …by promoting outcomes that are consistent with those produced in competitive markets…."* . The low-cost objective is only a general principle, which could be met in a variety of ways, and is not a binding requirement. In the Consultation Paper the Commission provides no evidence that its particular low cost approaches to determining key inputs to set the DPP are consistent with the overall purpose.

In the absence of any assurance that the forecast of each supplier's capex, opex and other line items have been independently verified there is a risk that the information is not accurate and the forecasts are higher than necessary, resulting in a higher allowable revenue. The Commission acknowledges that by relying on each supplier's forecast it provides suppliers with an incentive to systematically bias their forecast to increase their starting price. Contact supports the imposition of a 20% limit to each supplier's forecast average expenditure for the years 2012 to 2017 to constrain the potential for systematic bias. Contact supports a regulatory setting that encourages the application of a customised price path.

Contact supports the Commission's position that "*regulated suppliers have over-stated the risks associated with a customised price-quality path proposal*". Any supplier acting efficiently should be able to earn normal returns under a customised price path, and there should not be excessive costs involved in verifying a supplier of gas pipeline services information.

Robust quality standards are needed

The Commission acknowledges the development of robust quality standards is critical to a successful regulatory regime without which the price path might provide suppliers with an incentive to cut costs by compromising on quality. It is not sufficient to introduce only an emergency response

[1] Commerce Commission, *Regulatory Provisions of the Commerce Act 1986: Discussion Paper*, *19 December 2008 (*paragraph 150).

time target. The Commission must put in place reliability based standards as without such standards there is an increased risk that suppliers of gas pipeline services, some of which will face considerable rate shock if the proposed DPP becomes final, will reduce spend on networks leading to a reduction in quality.

Contact's view is that reliability, safety and response time to incidents and outages are critical and that a failure to meet reasonable objective standards should have a financial cost to the relevant supplier.

Additionally, Contact believes that the suppliers are not sufficiently innovative in their products and pricing and that the industry could operate more efficiently. The DPP doesn't seek to address that. As examples, it would be valuable and useful for consumers if suppliers offered gas parking services, peaking products and more flexible gas nomination services and rights across both gas transmission pipelines. The DPP revenue cap appears to be a roadblock to the widespread provision of these services or in fact any innovation that may add value and efficiency to the systems and users.

We recognise that it is difficult for the DPP to incorporate objective standards (and consequences) for innovation. None-the-less, we are aware that the UK regulator, Ofgem, has addressed a number of these issues. In brief they have developed a model which seeks to reward innovation and sets a long term framework to encourage a more flexible and forward looking approach from regulated companies (**RIIO model**).

The RIIO model (RIIO stands for Revenue = Incentives + Innovation + Outputs) sets outputs that network companies are expected to deliver including; customer satisfaction, reliability and availability, safe services, connection terms, environmental impact and social obligations.

We do not advocate for more complexity – but we do suggest that the Commission review some international material to see if there is a simple means of incentivising innovation.

Other quality standards the Commission could consider range from an overarching standard such as there should be "no material deterioration in quality" to more specific measures such as:

- Gas pressure – ensuring that all gas supplied to consumers ensures safe supply, passage and use of the gas where it is used for its intended purpose in a properly functioning installation.
- Odorisation – ensuring that all gas in a distribution system or supplied from a distribution system is odorised to the required level.

Other Regulation

The Commission acknowledges that suppliers of gas pipeline services are subject to a number of regulatory mechanisms that contribute to the safe and reliable supply of gas. We do not wish the Commission to duplicate or create different standards. However, these other regulations can be a useful source for determining whether the suppliers have met reasonable standards.

Consideration to be given to legislative change – return of comparative benchmarking

As Contact highlighted in its submission on the EDB Consultation we suggest that the Commission bring to the attention of Government the desire for the removal of the prohibition contained in section 53P(10) of the Act on the Commission using comparative benchmarking on efficiency in order to set starting prices, rates of change, quality standards, or incentives to improve quality of supply. Contact understands that the prohibition on comparative benchmarking was introduced because of high levels of dissatisfaction amongst network companies and officials with the way that comparative benchmarking was applied under the old Part 4A regime. This tension could perhaps be reduced by also legislating for an “Office of the Consumer Advocate” (**OCA**) which is seen in other regulatory jurisdictions. The OCA would be part of the Commission, but would be specifically charged with representing consumer interests. In terms of comparative benchmarking, the OCA would be able to sponsor a study, the network companies would be able to sponsor their own study and the Commission’s network regulatory staff would be able to adopt a demonstrably neutral role in balancing the interests of the two sides.

Conclusion

We submit that the Commission’s draft decision gives insufficient emphasis on quality standards and encouraging innovation.

The gas industry has a number of quality standards that apply to it that are found in primary and secondary legislation but unless there is a linking of the quality standards to the default price-quality path the incentives are diluted. We urge the Commission to undertake further work in this area to assure the industry that it has achieved the best result it can in relation to quality standards. Whilst providers of gas pipeline services would be grateful of light handed regulation in this area but gas retailers and consumers look to the Commission to provide sufficient regulation to protect their interests.