

How we propose to implement the Default Price-Quality Paths for Gas Pipeline Services

Date: 8 February 2013

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1. Introduction

Purpose of this paper

- 1.1 This paper invites submissions on:
 - 1.1.1 the drafting of the default price-quality path determinations for gas pipeline services; and
 - 1.1.2 the treatment of any pass-through and recoverable costs that are not yet reflected in prices.
- 1.2 The deadline for making submissions is **5pm, Monday 18 February 2013**.

Setting default price-quality paths for gas pipeline services

- 1.3 On 24 October 2012, we published a revised draft decision to set the default price-quality paths for gas pipeline services. Each of these paths will specify the maximum price, and minimum quality standards, that a supplier must comply with during the regulatory period, ie, 1 July 2013 to 30 September 2017.
- 1.4 In our revised draft decision, we sought views on:
 - 1.4.1 our reasons for the default price-quality paths that we proposed, which we set out in a 'draft reasons paper';¹ and
 - 1.4.2 the implementation of the default price-quality paths that we proposed, which were included in 'draft determinations' for gas transmission and gas distribution services.²
- 1.5 We have now considered all the material received in response to our revised draft decision, and we expect to publish a final decision on 28 February 2013.³ The updated draft determinations reflect some of the submissions made on the draft determinations. Our response to other submissions received to date will be discussed in the final reasons paper.

¹ Commerce Commission, *Revised Draft Decision on the Initial Default Price-Quality Paths for Gas Pipeline Services*, 24 October 2012.

² Commerce Commission, *Gas Distribution Default Price-Quality Path Determination 2013 Consultation Draft*, 24 October 2012; and Commerce Commission, *Gas Transmission Default Price-Quality Path Determination 2013 Consultation Draft*, 24 October 2012.

³ A full list of materials received in consultation on the Revised Draft Reset is available at <http://www.comcom.govt.nz/initial-default-price-quality-path/>.

Drafting suggestions before the final determinations

- 1.6 Before we publish our final decision, we invite drafting suggestions on the determinations for both gas transmission and gas distribution services. To this end, Chapter 2 of this paper includes a list of specific matters that should be reflected in the 'updated draft determinations that we have published alongside this paper.'⁴
- 1.7 We therefore welcome submissions on the extent to which the updated draft determinations reflect the list of specific matters that are set out in Chapter 2.

Treatment of any pass-through and recoverable costs that are not yet reflected in prices

- 1.8 In Chapter 3, we have set out a revised position on the treatment of any pass-through and recoverable costs that are not yet reflected in prices. This follows on from the notification we provided to parties on Monday 4 February 2013 about the way in which our thinking has developed.
- 1.9 We welcome views on our updated position and the proposed options for implementation.

How you can provide your views

- 1.10 Submissions are due by **5pm Monday, 18 February 2013**.

Address for responses

- 1.11 You should address your responses to:

John McLaren (Chief Adviser, Regulation Branch)
c/o regulation.branch@comcom.govt.nz

- 1.12 Responses should be provided in both MS Word and PDF file formats.

Requests for confidentiality

- 1.13 While we discourage requests for non-disclosure of submissions, we recognise that there may be cases where parties that make submissions wish to provide information in confidence. We offer the following guidance.
- 1.13.1 If it is necessary to include confidential material in a submission, the information should be clearly marked.

⁴ The near-final determinations are updated versions of the draft determinations, which highlight all the drafting changes that have been made since the draft determinations were published on 24 October 2012.

- 1.13.2 Both confidential and public versions of the submission should be provided.
 - 1.13.3 The responsibility for ensuring that confidential information is not included in a public version of a submission rests entirely with the party making the submission.
- 1.14 We request that you provide multiple versions of your submission if it contains confidential information or if you wish for the published electronic copies to be 'locked'. This is because we intend to publish all submissions on our website. Where relevant, please provide both an 'unlocked' electronic copy of your submission, and a clearly labelled 'public version'.

2. Matters reflected in the updated draft determinations

Purpose of this chapter

- 2.1 This chapter sets out specific matters that are intended to be reflected in the updated draft determinations published alongside this paper. We invite you to highlight any instances in which the updated draft determinations do not reflect this list.

General guidance

- 2.2 The final determinations will set the default price-quality paths applying to gas pipeline services from 1 July 2013 to 30 September 2017.
- 2.3 Table 3.1 overleaf sets out the specific matters that should be reflected in the updated draft determinations published alongside this paper. Interested parties should note that:
- 2.3.1 all relevant input methodologies have been applied in the updated draft determinations; and
 - 2.3.2 the tables in the updated draft determinations do not contain any numbers.

Table 2.1: Matters included in the updated draft determinations

Topic	Description
<p>What services and suppliers are subject to each determination</p> <p><i>Distribution and Transmission</i></p> <p><i>Clause 3</i></p>	<p>There are two determinations setting out the default price-quality paths for suppliers of gas pipeline services:</p> <ul style="list-style-type: none"> • one determination applying to gas distribution businesses; and • a second determination applying to gas transmission businesses. <p>Clause 1.1.4 of the input methodologies determination for gas distribution services defines what a gas distribution business is, and clause 1.1.4 of the input methodologies determination for gas transmission services defines what a gas transmission business is.</p>
<p>When the determinations take effect, and what the duration of regulatory period is</p> <p><i>Distribution and Transmission</i></p>	<p>The determinations take effect on 1 July 2013, and the regulatory period spans four years and three months from 1 July 2013 to 30 September 2017.</p>
<p>What is the timeframe for submitting a customised price-quality path proposal</p> <p><i>Distribution and Transmission</i></p> <p><i>Clause 7</i></p>	<p>Suppliers may submit a customised price-quality path proposal at any time except during the final 12 months of the regulatory period.</p>
<p>Starting prices for each supplier</p> <p><i>Distribution</i></p> <p><i>Schedule 1.</i></p> <p><i>Transmission</i></p> <p><i>Schedule 2.</i></p>	<p>A maximum allowable revenue figure is specified for each supplier. For MDL the figure relates to year ending 30 June 2014; for all other suppliers the figure relates the year ending 30 September 2013.</p> <p>The figures will be rounded to three decimal places.</p>

Topic	Description
<p>Treatment of pass-through costs and recoverable costs <i>Distribution</i> <i>Schedule 5.</i> <i>Transmission</i> <i>Schedule 6.</i></p>	<p>The individual pass-through cost or recoverable cost amounts that are used to calculate allowable notional revenue and notional revenue must:</p> <ul style="list-style-type: none"> • be known, and not forecast, when the supplier sets its prices; • not have already been recovered by the supplier; and • not relate to costs that were incurred by the supplier prior to the regulatory period (this is our revised view subject to consultation). <p>Pass-through costs and recoverable costs that become known after the supplier sets its prices may be claimed in a future period and may be adjusted for the time value of money.</p>
<p>Definition of balancing gas <i>Transmission</i></p>	<p>The definition of recoverable cost is consistent with the definition set out in clause 1.1.4 of the input methodology determinations for gas distribution and gas transmission services. In relation to this, we are currently consulting on an amendment to the input methodologies definition of balancing gas that would mean that costs allocated to welded parties for balancing gas will be part of the definition as well as balancing gas costs allocated to shippers.</p>
<p>Balancing gas approval process <i>Transmission</i> <i>Clause 12 and Schedule 7</i></p>	<p>An annual balancing gas statement must be submitted for the Commission's approval by</p> <ul style="list-style-type: none"> • 28 February 2014, 27 February 2015, and 26 February 2016 for Vector; and • 31 January 2014, 30 January 2015, 29 January 2016, 27 January 2017 for MDL.. <p>The statement must include the net cost or credit amount arising from supplier's purchase or sale of balancing gas that has not been allocated to a welded party or person shipping gas on the supplier's network. The statement must also include relevant information and calculations used to derive the net cost or credit amount, including:</p> <ul style="list-style-type: none"> • the date, quantity, price and sale or purchase amount for each transaction; and • the shipper/welded party name, date, quantity, price and credit or debit amount for each allocation of balancing gas to a shipper or welded party. <p>The Commission will notify each gas transmission business of the net cost or credit amount to be treated as a recoverable cost prior to each pricing year.</p>

Topic	Description
Pass-through of Electricity and Gas Complaints Commission levies <i>Transmission</i>	<p>The definition of pass-through costs is consistent with the definition set out in clause 1.1.4 of the input methodology determinations for gas distribution and gas transmission services. In relation to this, we are currently consulting on an amendment to the input methodologies definition which would allow gas transmission businesses to treat Electricity and Gas Complaints Commission levies as pass-through costs.</p>
Treatment of Unaccounted for Gas <i>Transmission</i>	<p>We intend to publish a clarification on our website shortly to confirm that unaccounted for gas is considered under the input methodologies definition of balancing gas.</p>
Treatment of compressor fuel <i>Transmission</i>	<p>Compressor fuel costs are not considered as a recoverable cost.</p>
Calculation and application of claw-back <i>Distribution</i> <i>Clause 8.5 and Schedule 6</i>	<p>Any suppliers that are subject to claw-back provisions will be specified.</p> <p>The determination sets out a process for calculating the amount a supplier is required to claw-back and the process for spreading the recovery of the claw-back amount over the regulatory period. In particular:</p> <ul style="list-style-type: none"> • For each pricing year (full or part) prior to 28 February 2013, the supplier calculates the difference between the revenue it earned in that year (net of pass-through cost, recoverable costs and other regulated income) and a corresponding 'regulated revenue' figure, which is adjusted for the time value of money. Regulated revenue is calculated by capping annual revenue increases from 1 January 2008 by CPI and constant price revenue growth. • The total amount of claw-back is partially recovered in each year of the regulatory period and adjusted for the time value of money. Any claw-back relating to the pricing year just prior to the regulatory period is not recovered in the first assessment period.

Topic	Description
<p>How the price path (price and revenue) is set and assessed</p> <p><i>Distribution</i></p> <p><i>Clause 8.4 and Schedules 3 and 4.</i></p> <p><i>Transmission</i></p> <p><i>Schedules 4 and 5.</i></p>	<p>We have set a weighted average price cap for distribution services and a total revenue cap for transmission services. In both instances we use allowable notional revenue and notional revenue to assess compliance.</p> <p>For the first 15 months of the regulatory period (for suppliers other than MDL) and any other given year, a supplier's allowable notional revenue must not exceed its notional revenue.</p> <p>The formulas for determining allowable notional revenue and notional revenue are materially the same as set out in our October 2012 revised draft decision. For distribution, however, the formula for calculating allowable notional revenue for 2013/14 has been modified to be a function of allowable revenue for 2012/13, rather than the prices that were permitted in 2012/13 and corresponding quantities from 2011/12.</p>
<p>Calculating CPI</p>	<p>CPI for any given quarter year is the consumer price index stipulated in the 'All Groups Index SE9A' as published by Statistics New Zealand.</p> <p>The annual allowed inflation adjustment to prices/revenues is calculated using the most eight most recent quarterly CPI values that are available 6 months prior to a pricing year.</p>
<p>What quality standards apply</p> <p><i>Distribution and Transmission</i></p> <p><i>Clause 9</i></p>	<p>Quality standards are based on response times to emergencies where:</p> <ul style="list-style-type: none"> • Gas distribution businesses and gas transmission businesses must respond to 100% of emergencies in no more than 180 minutes. • Gas distribution businesses must respond to 80% of emergencies in no more than 60 minutes. <p>Suppliers may apply to the Commission to exclude specific incidents from consideration towards the quality standards within 30 days of the incident occurring. The list of such incidents is not specified in the determination.</p>
<p>Definition of emergencies</p> <p><i>Distribution and Transmission</i></p>	<p>There are separate definitions of emergencies for each service:</p> <ul style="list-style-type: none"> • For gas distribution services, an emergency means an unplanned escape and/or ignition of gas that requires the active involvement of any emergency service (i.e., fire service, ambulance); or an unplanned disruption in the supply of gas that affects more than five ICPs; or the need to evacuate premises as the result of escape or ignition of gas. • For gas transmission services, an emergency means an incident that is, or will be, reported under the 'Guidelines for a Certificate of Fitness for High-Pressure Gas and Liquids Transmission Pipelines' that the gas transmission business considers a representative of the gas transmission businesses is required to immediately respond to the incident.

Topic	Description
Definition of consumer <i>Transmission</i>	The definition of pass-through costs is consistent with the definition set out in clause 1.1.4 of the input methodology determinations for gas distribution and gas transmission services. In relation to this, welded parties and shippers on a supplier's network are also considered consumers for the purposes of clause 11.3.2(d)(iv).
Definition of quantities <i>Distribution and transmission</i> <i>Clause 4.2</i>	The definition of pass-through costs is consistent with the definition set out in clause 3.1.1(5) of the input methodology determinations for gas distribution and gas transmission services.
What rate(s) of change apply to the price path	The industry wide rate of change is 0%.
Treatment of transactions <i>Distribution</i> <i>Clause 10 and Schedule 7.</i> <i>Transmission</i> <i>Clause 10 and Schedule 8.</i>	<p>If a supplier completes an amalgamation, or a merger or acquisition, the supplier must aggregate its allowable notional revenue, notional revenue and quality standard values for the purposes of compliance with the price path and quality standards.</p> <p>For smaller transactions, a supplier's price path is required to be adjusted in situations where assets are transferred to or from the supplier leading to consumers being supplied gas pipelines services by a different provider. In particular:</p> <ul style="list-style-type: none"> • Suppliers are permitted to recover revenue from consumers for additional services that are supplied due to an acquisition. Conversely, suppliers are not permitted to recover revenue for services provided to customers they no longer supply. • The prices for any additional services will not exceed the prices that were charged by the previous supplier, adjusted by inflation. <p>Where the required aggregations or adjustments cannot be calculated due to a lack of information available beyond the control of a gas distribution business, an alternative assessment approach can be used provided it has a substantially equivalent effect.</p> <p>Where an amalgamation, merger or acquisition, or transaction occurs where the supplier's asset base or revenues change by greater than 10% as a result of an asset transaction, the supplier must notify the Commission.</p>

Topic	Description
Compliance information <i>Distribution and transmission</i> <i>Clause 11</i>	<p>Compliance with the price path and the quality standards are, in general, assessed following a supplier's pricing year. The exception being that compliance will be assessed following the first 15 months of the regulatory period for all suppliers other than MDL.</p> <p>A supplier will have 50 working days following the end of each assessment period to submit a compliance statement to the Commission and a further 5 working days to publish the compliance statement on its website.</p> <p>A compliance statement must demonstrate whether the supplier has complied with the price path and quality standards, and include relevant supporting information and calculations.</p> <p>Where a supplier (distribution only) restructures its prices:</p> <ul style="list-style-type: none"> • the supplier must demonstrate that allowable notional revenue has not increased as a result of the restructure; or • if this is not possible, the supplier must demonstrate that its forecast revenue has not increased as a result of the restructure, or that the substance of the price path provisions have been complied with. <p>Each compliance statement must be accompanied by an independent audit report and Directors' certificate.</p>

3. Additional matters for consultation

Purpose of this chapter

- 3.1 This chapter sets out some additional matters for consultation including:
- 3.1.1 our revised position on the treatment of pass-through and recoverable costs that may not yet be reflected in prices; and
 - 3.1.2 the treatment of appeal costs for the year ending 30 June 2011.

The treatment of pass-through and recoverable costs that may not yet be reflected in prices

- 3.2 Under a default price-quality path, suppliers will be able to pass-through certain costs to consumers. These costs include for example, rates and levies, and transmission charges. We refer to the two main types of these costs as ‘pass through costs’ and ‘recoverable costs’.
- 3.3 The recovery of pass through costs and recoverable costs under the default price-quality paths will be lagged to ensure these costs known to suppliers when setting prices. This is because, in some cases, the costs are unknown when the supplier sets prices and can be difficult to predict.
- 3.4 The question we are addressing in this paper is whether to allow recovery of any costs that meet the definition of pass through and recoverable costs, but which have not been recovered prior to the start of the regulatory period. This section sets out our previous position on this matter, and an overview of our revised position.

Our previous position

- 3.5 In our October 2012 draft decision we proposed that all suppliers would be able to recover pass-through or recoverable costs that were incurred prior to the regulatory period to the extent that the costs have not already been passed through to, or recovered from, consumers.⁵
- 3.6 We also proposed that, to be able to recover these costs, suppliers would have to provide sufficient information to demonstrate the amount of cost to be recovered as part of their annual compliance statement.⁶

⁵ Commerce Commission, *Revised Draft Decision on the Initial Default Price-Quality Paths for Gas Pipeline Services*, 24 October 2012, pp 101-102.

⁶ Commerce Commission, *Gas Distribution Default Price-Quality Path Determination 2013 Consultation Draft*, 24 October 2012, clause 11.2.2(b).

Our revised position

- 3.7 Having considered how this approach would work in more detail, our revised position is that:
- 3.7.1 For suppliers not previously subject to the Gas Authorisations, we do not consider pass-through and recoverable costs should be carried over into the default price-quality paths.⁷ In our view, these suppliers were able to set prices in a way to recover the costs that are included in the definition of pass-through and recoverable costs in the input methodologies for gas pipeline services. One potential exception to this is outstanding net balances of balancing gas, discussed at paragraphs [3.18-3.21] below.
 - 3.7.2 For suppliers previously subject to the Gas Authorisations, there may be merit in a consistent and continuous recovery of pass-through and recoverable costs as these suppliers transition from the Gas Authorisations to default price-quality paths. If so, additional adjustments may be required to the recovery of costs to give effect to this approach. We propose adopting one of the options below to assess the amount of costs that should be recovered.
- 3.8 For suppliers previously on the Gas Authorisations, we propose one of the two options below for determining the unrecovered amounts:
- 3.8.1 A formula which approximates the value of unrecovered pass-through and recoverable costs by projecting the price path under the Gas Authorisations forward for the period following the expiry of the Gas Authorisations on 1 July 2012; or
 - 3.8.2 An approval process where the onus is on the supplier to demonstrate any costs they wish to recover that were not previously taken into account when setting prices.
- 3.9 Further information about each of the potential options is set out below.

⁷ Commerce Act (Powerco Natural Gas Services) Authorisation 2008; and Commerce Act (Vector Natural Gas Services) Authorisation 2008.

Formula for calculating unrecovered pass-through and recoverable costs

3.10 Under our preferred approach, the amount that has not yet been recovered would be approximated using a formula. In particular, for the year ending 30 September 2013, and with reference to clause 6.2.2 of the Gas Authorisation:

3.10.1 The right hand side of the first expression would be calculated by assuming that the forecast allowance for the 2013 year is equal to the forecast allowance in the 2012 year;⁸

3.10.2 The left hand side of the first expression would also be calculated; and

3.10.3 the second term would be subtracted from the first to calculate the allowed adjustment.

Figure 3.1: Clause 6.2.2 of the Gas Authorisations

6.2.2 Prices after the commencement period

Prices during each pricing year commencing on or after 1 October 2009 must be such that the notional revenue of Powerco calculated in accordance with the left-hand side of the following expression *does not exceed* the allowable notional revenue of Powerco calculated in accordance with the right-hand side of the following expression:

$$\sum P_{ij,t} Q_{ij,ref} \leq (\sum P_{ij,t-1} Q_{ij,ref} - C_{t-1})(1 + \Delta CPI_t)(1 - X) + C_t$$

where:

- t indicates the calendar year to which reference is being made
- i is service i
- j is component j of service i
- $P_{ij,t}$ is the price of component j of service i in the year commencing 1 October in calendar year t
- $P_{ij,t-1}$ is the price of the component j of service i in the year commencing 1 October in calendar year t-1
- X is specified in *Schedule 1*
- $Q_{ij,ref}$ is the reference quantity of component j of service i used for setting the quantity weights, which is to be the audited quantity for each component of price for the year ending 30 September of year t-1.
- C_t is the allowed increase (decrease) in pass-through costs for the pricing year commencing 1 October in calendar year t above (below) the forecast allowance specified in *Schedule 1*
- C_{t-1} is the allowed increase (decrease) in pass-through costs for the pricing year commencing 1 October in calendar year t-1 above (below) the forecast allowance specified in *Schedule 1*
- ΔCPI_t is the average change in the quarterly Consumer Price Index over the calendar year that ends on 31 March in the year t, calculated in accordance with the following expression:

$$\Delta CPI_t = \frac{CPI_{Jan,t-1} + CPI_{Sep,t-1} + CPI_{Dec,t-1} + CPI_{Mar,t}}{CPI_{Jan,t-2} + CPI_{Sep,t-2} + CPI_{Dec,t-2} + CPI_{Mar,t-1}} - 1$$

where 't' refers to calendar years ending 31 December

⁸ The forecast allowance for the 2012 year is set out in each Schedule 1 of the Authorisations.

- 3.11 The benefit of our preferred approach is that it is simple and relatively low cost to implement, but we recognise that it will only provide an approximation of the unrecovered amounts.

Approval process for demonstrating unrecovered pass-through and recoverable costs

- 3.12 The alternative approach that we are considering is an approval process in which we would be required to approve each cost individually. Under this approach, the supplier must demonstrate to our satisfaction that a cost has not already been passed through to, or recovered from, consumers.
- 3.13 For the approval process to work, we would have to set out the information that the supplier would have to provide to allow us to consider whether the cost should be passed through to, or recovered from, consumers. For example, for each cost, a supplier may have to provide information about:
- 3.13.1 the amount attributed to the disclosure year in question; and
 - 3.13.2 an explanation for why the cost was not reflected in its pricing prior to the start of the default price-quality path.
- 3.14 The benefit of this approach would be that we could be more confident that only legitimate amounts are passed through to, or recovered from, consumers. However, the approach would also be likely to be more resource-intensive, and suppliers may have difficulty providing information that is sufficient for our purposes.

We are seeking your views on a preferred option and any refinements

- 3.15 We are seeking feedback on which of the two options presented above interested parties prefer, and any suggested drafting refinements.⁹ We also welcome any further options you may have.

Balancing gas costs for businesses not previously subject to the Authorisations

- 3.16 We are also considering allowing businesses not previously subject to the Gas Authorisations to recover costs associated with balancing gas. This is an exception to our general view that these businesses would have been able to recover pass-through and recoverable costs in setting their prices prior to the default price-quality paths.

⁹ We do not propose to include both options in the determination as we would be unable to determine whether the amounts submitted for approval against the criteria had already been provided for by applying the formula.

- 3.17 Balancing gas is a potential exception as we understand these costs are lagged subject to individually negotiated contracts, and often held over time in a net balancing account. These characteristics are unique, and lead us to believe that the net balance of these accounts over time may leave either suppliers or consumers out of pocket if these costs are not able to be carried over into the default price-quality paths.
- 3.18 To address this, we propose three options:
- 3.18.1 Suppliers recover or pay any outstanding balancing gas amounts prior to the start of the default price-quality paths. This would mean no costs are required to be recovered under the default price-quality paths;
 - 3.18.2 Any payments made or received for the outstanding balancing gas amounts would not be taken into account in assessing compliance with the default price-quality path, ie, they would be listed as an excluded item; or
 - 3.18.3 Before the end of the first assessment period, the Commission would use data obtained under s53ZD to determine an adjustment to the amount each supplier can recover under the default price-quality paths.
- 3.19 We are seeking your feedback on whether suppliers not previously subject to the Gas Authorisations should be able to recover any prior balancing gas amounts, and if so, which is your preferred option for recovery including any suggested drafting.

Appeal costs for the year ending 30 June 2011

- 3.20 The Commission intends to use 2011 as the base year for forecasting operating costs for the Gas DPP. Powerco and Vector may have included the legal costs of appeals against input methodology determinations under Part 4 of the Act in their 2011 operating costs.
- 3.21 We consider that section 52T(1)(c)(i) prevents these legal costs (or the legal costs of appeals under sections 91 or 97 of the Act) from being passed through to prices. We therefore propose to exclude 2011 appeal costs from the forecasted operating costs. We anticipate that the amount of appeal costs for 2011 will be relatively low, given that the appeal process commenced in February 2011 when parties filed their notices of appeal.
- 3.22 We invite your feedback on our view.