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Dr Mark Berry
Chair
Commerce Commission
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By email

Dear Mark

Submission on the Revised Draft Decision on the Initial Default Price-Quality Paths for Gas Pipeline Services

1. Following the November 2011 consultations on the "Initial Default Price-Quality Paths for Gas Pipeline Businesses, Draft Reasons Paper", dated 21 November 2011, the Commerce Commission (the Commission) has now published further consultation: "Revised Draft Decision on the Initial Default Price-Quality Paths for Gas Pipeline Services", dated 24 October 2012 (the Revised Draft Decision).

2. This submission forms GasNet's response to the Revised Draft Decision. It addresses the matters most relevant to our business. In particular, we concentrate on the following aspects of the Revised Draft Decision:
   - the proposal to apply claw-back to GasNet
   - the calculation of claw-back
   - the proposed CPP allowance for GasNet
   - projecting opex
   - projecting capex
   - materiality of decisions to GasNet
   - compliance timing
   - the quality standard

Proposal to apply claw-back

3. Section 55F(2) of Part 4 of the Commerce Act 1986 (Part 4 or the Act) sets out that claw-back may be applied to a Gas Pipeline Business (GPB) where weighted average prices have increased by more than CPI between 1 January 2008 and the date when a DPP Determination comes into force, as follows:

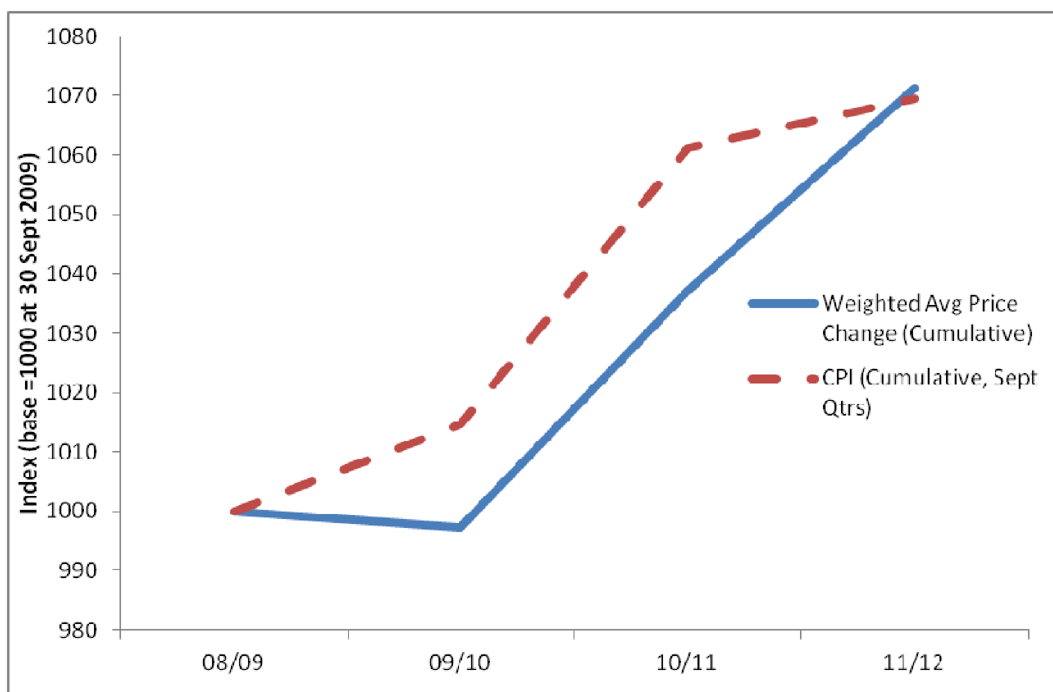
   > *… if a supplier has increased its weighted average prices by more than the movement, or forecast movement, in the all groups index number of the New Zealand Consumer Price Index in the period beginning 1 January 2008 and ending with the date that the determination is made, the Commission may apply claw-back to the extent of requiring the supplier to lower its prices in order to compensate consumers for some or all of any over-recovery of revenues that occurred during that period*

4. The Revised Draft Decision proposes that claw-back of the full amount of over-recovery be applied to GasNet. This follows consideration of our pricing over the period 1 October 2008 to 30 September 2012. Claw-back is proposed to be recovered in equal instalments (in future value terms) over the four DPP assessment periods, commencing 1 July 2013.

5. GasNet maintains that the imposition of the proposed claw-back is unduly retrospective. The majority of this proposed claw-back amount relates to price increases that took effect on 1 October 2008, 12 working days after the Amendment Act gained assent into Parliament (on 16 September 2008). GasNet's decision to increase prices on 1 October 2008 was made prior to the date of assent, and revenue attributed to the price increases was earned prior to the 1 April 2009 commencement date for the Commerce Act amendment.

6. Subsequent to this initial pricing period our price increases (each taking effect on 1 October 2009, 2010 and 2011) have resulted in constant growth price increases of 7%, which is consistent with CPI over the same period, as illustrated below.

Figure 1: GasNet's cumulative change in weighted average prices relative to CPI (post Amendment Act period 1 Oct 2009 – 30 Sept 2012)



Note:

- GasNet's 08/09 prices are the base year for movements in prices. Price movements based on change in prices lagged one year assuming quantities held constant
- CPI movements relative to 2009 September Quarter of all groups price index

7. The pricing decisions we have made since the Amendment Act came into force have complied with the intent of section 55F(2). We submit that a decision to pass back revenue earned as a consequence of decisions made prior to the legislation is not consistent with the Purpose Statement. The retrospective nature of this proposed decision, which reflects pricing decisions made over four years ago, undermines regulatory certainty and hence incentives to invest. Further, there has been no assessment as to whether this decision is consistent with subparts b), c) and d) of the Part 4 Purpose Statement. We note that the Commission has the discretion under section 55F(2) to partially apply claw-back or not apply it at all. The Commission could therefore choose to ignore this initial period in order to better give effect to the purpose of Part 4 regulation.

8. Accordingly we do not support the proposed claw-back component of the DPP to apply to GasNet. We note that this proposed revenue reduction comes at a time when we must increase our operating costs (discussed below) in order to meet the substantial compliance obligations which have been imposed on us as a consequence of Part 4 regulation. We do not believe either of these outcomes is consistent with the long term benefits of consumers.

9. Without prejudice to these conclusions we offer the following comments on the proposed calculation of claw-back set out in Box L9 of the Revised Draft Decision.

Claw-back calculation

10. The proposed claw-back calculation compares actual revenue net of pass-through and recoverable costs (i.e. net revenue) with actual net revenue from the prior year escalated by CPI and growth. This is calculated for each pricing year over the period 1 October 2008 to 30 September 2012. The sum of the annual differences are discounted to derive a claw-back value; the future value of this being apportioned equally across the four future DPP assessment periods.

11. In the event that claw-back is included in the DPP Determination, we support the proposal that it be implemented over the full DPP period in order to smooth the revenue and pricing impact. We make the following observations regarding the proposed claw-back formula.

Net Revenue

12. We believe that the definition of net revenue is ambiguous and does not align with section 55F(2). As currently defined, it is proposed that net revenue includes other (non gas distribution service charge) revenues. We submit that the definition of net revenue is amended to exclude revenue which does not arise from gas distribution service charges. This is consistent with section 55F(2) which refers to weighted average prices. Accordingly, 'Other regulatory income' should be specifically excluded from the definition, to ensure consistency with section 55F(2). It is not appropriate to apply a CPI constraint to other regulatory revenue which is not earned through prices.

Discount rates

13. The Revised Draft Decision seeks comments on the appropriate discount rate to apply in the derivation of the value of claw-back to be recovered in future years. The following options are included:
    - mid-point WACC
    - 75th percentile WACC
    - cost of debt
    - interest rates that consumer face[1].

14. The Revised Draft Decision indicates that it is proposed that the 75th percentile estimate of the cost of capital is used to calculate the claw-back recovery. We note that the recent electricity distribution businesses (EDB) DPP decision uses a different discount rate being an estimate of the cost of debt for suppliers and consumers. This decision appears to have been largely influenced by Vector's submissions on the matter.

15. We note that Vector, and their advisors CEG, suggested that it may be appropriate to use different discount rates for claw-back under different circumstances, in particular whether the claw-back was in response to perceived over-recovery or under-recovery. We have not considered the situation where claw-back may be imposed in response to past under-recovery as section 55F(2) only anticipates claw-back of over-recoveries. In the situation where claw-back arises as a result of perceived over-recovery, we suggest that the proposition put forward by CEG is valid, i.e.:

[1] Revised Draft Decision, paragraphs L54-L55

In the case of claw-back of over recovery by a business one approach is, as pointed out by the Commission, to treat the amount to be clawed back as a loan from customers to the business and to assign a discount rate that reflected the risks attached to the repayment of the over-recovery. [2]

16. CEG then go on to suggest that a reasonable approach would be to set the discount rate equal to the cost of debt. We note that the Commission has adopted the pre-tax cost of debt assumption in its EDB DPP Determination in respect of claw-back[3]. In making this decision, the Commission also makes references to borrowing costs that consumers might face (i.e. mortgage rates) as a benchmark.

17. Consistent with this decision we recommend the use of the cost of debt assumption consistent with the GDB DPP WACC as specified in section 4.4.1(2) of the IMs. This is defined as the risk free rate plus debt premium plus debt issuance costs. We consider this recognises appropriate borrowing costs a consumer might face, incorporating the risk free rate and a reasonable debt margin.

Discount rate timing factors

18. Box L9 in the Revised Draft Decision includes the proposed claw-back formula. It specifies a time value of money term (TVa) for calculating the present value of claw-back at the beginning of the regulatory period (CR_t) and a time value of money term (TVr) for calculating the recovery of claw-back in each assessment period. Both terms include timing factors in order to calculate CR_t and recovery of this claw-back (in future value terms) for each applicable assessment period, respectively.

19. We question the validity of the proposed discount rate timing factors. As an example, the calculation of claw-back for the period 1 October 2008 to 30 September 2009 ($CR_{2008/09}$) is assigned a timing factor of 5 (or five years) in box L9. Assuming that CR_t is calculated with reference to 30 June 2013, being the beginning of the DPP regulatory period, then a timing factor of 5 assumes revenues are received five years prior, on 30 June 2008. This is three months prior to the start of the pricing year from which claw-back is being assessed.

[2] CEG, "Default price quality path reset", submitted on behalf of Vector, October 2012, section 4.1
[3] Supra n1, J26.

20. Similarly, we also question the timing factors used to calculate the recovery of claw-back for each future DPP assessment period. For the first assessment period, which comprises 15 months (1.25 years), the proposed timing factor of 1 assumes revenues are received on 30 June 2014. Revenue received in subsequent assessment periods is also assumed to be received on 30 June.

21. This is not consistent with either the pricing year (1 October – 30 September) or the DPP period (which aligns with this throughout the DPP regulatory period) with the additional three months from 1 July 2013 in the first assessment period.

22. The calculation of claw-back is also inconsistent with the mid-period discounting of revenues in the DPP financial model. This model assumes revenues are received 148 days prior to the end of each disclosure year. This assumption reflects the billing cycle in which revenue is received 20 days after the end of each month. Adopting the same 148 day assumption in the claw-back calculation for pricing years (i.e. ending 30 September) would better align the discounting of revenues in the DPP financial model with the discounting of claw-back. This would assume that revenues are received 148 days prior to the end of each pricing year ending 30 September (i.e. ensuring consistent billing across the pricing year).

23. To resolve these inconsistencies, we submit that the time value of money timing factors for claw-back should be calculated relative to 30 June 2013 and should assume the same 148 day assumption, consistent with that applied in the draft DPP financial model.

24. Calculating the number of days which fall between the 148 day assumption in each applicable year and 30 June 2013 and converting these to an annualised figure produces the following timing factors. We submit that these timing factors be adopted in the calculation set out in box L9.

Figure 2 – Proposed timing factors for claw-back calculation

Period reference	***Pricing Period***	***Revised Draft Decision proposed timing factor***	***GasNet proposed timing factor (2dp)***
TCR calculation periods			
A	*1 Oct 2008 – 1 Sep 2009*	*5*	***4.16*** [a]
B	*1 Oct 2009 – 1 Sep 2010*	*4*	***3.16***
C	*1 Oct 2010 – 1 Sep 2011*	*3*	***2.16***
D	*1 Oct 2011 – 1 Sep 2012*	*2*	***1.16***
Allocation to Future Assessment Periods			
1st Assessment Period	*1 Jul 2013 – 30 Sep 2014*	*1*	***0.84*** [b]
2nd Assessment Period	*1 Oct 2014 – 30 Sep 2015*	*2*	***1.84***
3rd Assessment Period	*1 Oct 2015 – 30 Sep 2016*	*3*	***2.85***
4th Assessment Period	*1 Oct 2016 – 30 Sep 2017*	*4*	***3.85***

Notes:

a) *i.e. 1 July 2013 to 148 days prior to end of pricing year = 1518 days.*
1518 days/ 365 days = 4.16

b) *i.e. 148 days prior to end of assessment period less 1 July 2013 = 308 days. 308 days / 365 days = 0.84. Assumes an initial period of 1.25 years as per the initial assessment period.*

c) *Assumes 365 days in year*

Other claw-back matters

25. We support the use of the CPI SE9A series unadjusted as a benchmark to assess the extent of any over recover through prices. This is consistent with section 55F(2).

GasNet CPP allowance

26. The Revised Draft Decision includes an additional allowance of $398k spread over the DPP period to reduce the probability of GasNet making a CPP application. This allowance is provided to GasNet in recognition of its smaller size. It recognises that a CPP application will be particularly costly for GasNet when expressed as a proportion of its revenue, and that the potential costs of making a CPP application are likely to outweigh its benefits. A CPP application could result in significant price increases simply to recover the costs of making an application. For example, a $1.5 million CPP application cost would increase prices by 33% (relative to 2011/12 revenue), or 7% spread over five years. The proposal for an allowance minimises the risk of this price shock occurring by lowering the probability of a CPP application having to be made.

27. We have submitted in the past that we do not see a CPP as a viable option for us, as it cannot be justified as being in the long-term interests of consumers. We acknowledge that the DPP is not intended to capture accurate forecasts of our regulatory business performance. However, this imposes undue risk on us as there is not a cost effective remedy available to us to correct forecast error.

28. While we broadly support the proposal for an additional CPP allowance, we consider that the assumed CPP application costs underpinning the allowance are conservative. In our view, the full cost of a CPP application is likely to exceed $1.5 million. Furthermore, not all of the costs we face can be treated as recoverable costs and passed on to consumers[4], meaning GasNet will incur costs that it is unable to recover. Based on our understanding of the requirements of a CPP application, we submit that total CPP application costs assumed in the calculation of the CPP allowance, including our own costs of preparing the CPP proposal which are non-recoverable, are likely to be in excess of $2 million.

Opex projections

29. Opex projections are set under the Revised Draft Decisions based on the Commission's calculations of the likely trends in opex for each GPB, with an adjustment to reflect increases in insurance costs. These projections are based on 2011 opex data for each GPB projected forward using assumptions regarding network scale, input prices, and partial productivity.
30. This method fails to take account of the increase in regulatory compliance and stakeholder management costs that GasNet will incur as a result of being subject to the Part 4 DPP and information disclosure determination (IDD). Unlike other GPBs (with the exception of MDL), GasNet has not previously incurred costs associated with preparing and auditing annual compliance statements. Further, the new IDD are significantly more onerous than those that have applied to us to date. While the 2011 base year opex includes some compliance costs, these are insufficient to meet the step change in regulatory compliance once the DPP and IDD come into effect. Thus we propose that an ongoing allowance recognising the full regulatory compliance costs GasNet will face is included in the opex projection.

[4] Only audit, verifier, engineer, and Commission costs can be treated as recoverable costs consistent with Section 3.1.3 of the IMs. GasNet's own costs of producing an application can not be treated as a recoverable cost.

31. Figure 3 presents our estimates of the additional ongoing regulatory costs we expect to incur and which we believe have not already been included in the Commission's projections. We submit these should be included in our opex projections. The estimates provide for additional labour costs to resource regulatory compliance activities and additional audit costs.

32. Ongoing audit costs and fees associated with GasNet's certification with the Safety Management System regime (SMS Audit Certification required by May 2013) have also not been factored into the Commission's projections. We submit that an annual allowance for these costs should also be included in our opex projections (as set out in Figure 3).

33. In addition to these ongoing costs, we also request a provision for one off costs in 2013/14 associated with:
    - The development of new AMP documents and other documents, such as pricing methodologies, required by the IDD
    - Modifications to our reporting systems required to generate regulatory information

34. We estimate these one-off costs could add another $75k to the 2013/14 operating cost forecast (as set out in figure 3).

Figure 3: Additional regulatory and safety management compliance costs (2012 dollars)

Cost item	$(000)
Additional labour costs (incl. support costs)	50pa
Audit fees DPP	30pa
Incremental audit fees IDD	30pa
SMS audit and fees	20pa
Total additional ongoing regulatory costs	**130pa**
20013/14 one off costs	**75**

35. Our 31 August 2012 section 53ZD notice information provided for annual insurance costs of $180k in 2012/13. This was based on 2011/12 insurance costs escalated for expected premium increases. Since providing this information our insurance policy premiums have actually increased by approximately $10,000 for 2012/13 to $190k. We anticipate these additional costs are likely to continue into future years. We submit that our 2012/13 insurance cost projections should be increased to $190k to accommodate actual premium increases.

Capex projections

36. Capex projections are set in the Revised Draft Decision using each GPBs network and non-network capex projections. GasNet's forecasts of network capex have been accepted by the Commission in the Revised Draft Decision. However, non-network capex was reduced by $186k based on the Commission's historical expenditure analysis.

37. While seemingly a small amount, this reduction has a significant impact on our operations. As table A2 of the Revised Draft Decision shows, this is a 25.2% reduction on non-network capex. This will have a significant impact upon our ability to operate and maintain the network.

38. We believe that the proposed approach which smoothes non-network capex is problematic as this expenditure is typically lumpy in nature, particularly given the small scale of our operation.

39. We submit that non-network capex should be based on the information we submitted to the Commission. This is consistent with network capex, which is based on supplier information capped to a 20% growth on historical average expenditure. Given the natural volatility as well as low materiality of non-network capex we propose that a higher cap should adopted than for network capex (e.g. 50%). The cap should be applied to aggregate non-network capex.

Materiality of decisions to GasNet

40. GasNet is concerned by the use of rounding in the determination. Table 2 of Schedule 2 of the determination sets out that GasNet's 2013 starting prices is $4.4m. This figure is rounded to millions of dollars and 1 decimal place from the Commission's modelled figure of $4,435 (expressed in $000). This means GasNet loses $35k or 0.8% of its allowable revenue due to rounding. While this level of rounding may be appropriate for Vector and Powerco it has a material impact on GasNet. We submit that starting prices should be expressed in thousands of dollars.

Gas DPP Financial Modelling

41. We note that the weighted average remaining life at year end in 2009/10 (cell D41 of the "Inputs" sheet) is incorrect at 32 years. It should be 27 years consistent with the value we resubmitted in our corrected section 53ZD disclosure information in

2012. 32 years was the now superseded value submitted in our earlier 2011 section 53ZD disclosure information.

Compliance Timing

42. Schedule 1 of the Revised Draft Decision specifies that GDBs have until 30 November to publish their annual compliance statements. These must include the initial price assessment, the price re-assessment at the end of the assessment period, and the quality standard assessment.

43. The proposed timeframes allow only 44 business days (excluding Labour Day) to produce and audit annual compliance statements. However, EDBs are required to publish their DPP compliance statements within 50 business days[5] and are not required to re-assess their prices.

44. To address this inconsistency, we submit that GPBs are also provided 50 business days. This provides for disclosure of annual assessments in early December, i.e: prior to the end of the calendar year, and before the Christmas/New Year break.

Quality Standard

45. The Revised Draft Decision proposes the following 'response times to emergencies' quality standard :
    - suppliers must respond to all emergencies in 180 minutes or less
    - gas distributors must respond to 80% of emergencies within 60 minutes.

46. It is proposed that 'response time to emergencies' is defined consistent with IDD as follows:

    "… the time elapsed from when an emergency is reported to a GDB representative until the GDB's personnel arrives at the location of the emergency"[6]

47. GasNet supports the proposed quality standard and alignment of the definition of "response times to emergencies" with IDD.

[5] EDB DPP Determination 2012, NZCC35 – clause 11.1
[6] IDD, schedule 16 definitions

Exemptions

48. It is proposed that GPBs may request exemptions for not meeting the standard. This may apply to specific events where it is not possible to comply with the standard (e.g. access was restricted, preventing personnel from accessing the emergency)[7].

49. We support the incorporation of this exemption in the Determination. However, we submit that the process and timeframe for the Commission to approve the exemption needs to be formalised to improve compliance certainty. It is important that GPBs have certainty about whether an event is exempt prior to finalising their annual compliance statements.

50. We propose that approval of a notification of an exempt event be made within 20 calendar days. This will ensure an event occurring at the end of the assessment period can be reported within the next month, and confirmation received prior to the submission of the compliance statement – within 50 working days (as proposed above).

Closing Remarks

51. If you have any queries in relation to this submission or would like further information regarding our responses to the section 53ZD notices, please contact me.

Yours sincerely,

Geoff Evans
General Manager

[7] Revised Draft Decision – para 5.10