

29 April 2010

Dr Mark Berry
Chair
Commerce Commission
P O Box 2351
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[By email]

Dear Mark

**Initial Default Price-Quality Path for Gas Pipeline Businesses – Issues Paper
Submission on Section 4: Form of Price Control**

1. The Commerce Commission (the Commission) published, in April 2010, an Issues Paper on the initial default price-quality path (initial DPP) for gas pipeline businesses (GPBs).
2. This submission reflects the views of GasNet on Section 4 (Form of Price Control) of the Issues Paper. GasNet will make a further submission on the other sections of the Issues Paper by the Commission's May 14 deadline. 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 customers.
3. GasNet welcomes the opportunity to engage with the Commission on the initial DPP. GasNet's primary concern is to work with the Commission to ensure that the development and application of the DPP do not impose regulatory costs which outweigh any benefits to consumers. GasNet is small in the context of the gas distribution sector¹, and it remains GasNet's view that the regulatory compliance burden under the new Part 4 of the Commerce Act is likely to be significantly higher than that it currently incurs. Our submission focuses on the issues of most relevance to gas distribution businesses (GDBs) and therefore does not address issues specific to gas transmission.

¹ For example, GasNet is smaller than Nova Energy's gas business, which is exempt from the new regulatory arrangements.

Introduction

4. Part 4 of the Commerce Act requires the Commission to reset starting prices at the beginning of the regulatory period as follows (clause 53P (3)):

(3) The starting prices must be either –

- a) the prices that applied at the end of the preceding regulatory period; or*
- b) prices, determined by the Commission, that are based on the current and projected profitability of each supplier.*

(4) Starting prices set in accordance with subsection (3) (b) must not seek to recover any excessive profits made during any earlier period.

Price path

5. GasNet concurs with the Commission's view that incentive regulation best seeks to strengthen the incentives regulated firms face to operate effectively. This is consistent with section 52A (1) (a) – (c) of the Commerce Act 1986 which states:

(1) The purpose of this Part is to promote the long-term benefit of consumers in markets referred to in section 52 by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services –

- (a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and*
- (b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and*
- (c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices*

6. Appropriate incentive regulation should enable GasNet to recover its costs and ensure service quality is maintained at a level consistent with consumer demands, while enabling it to benefit from potential cost reductions and share those benefits with consumers over time.
7. Although Section 4 of the Issues Paper addresses the form of price control, the Commission should be mindful of the fact that price and quality are inextricably linked. It is therefore important for the Commission to be mindful of consumer preferences and willingness to pay for quality. A regulatory requirement for suppliers to ensure service quality is maintained or improved, significantly affects the ability of GDBs to reduce or maintain costs.

8. GasNet agrees with the Commission's view that the implementation of a price-cap has an effect on the incentives associated with the cap. GasNet notes that discussion concerning the price path assessment formula and its components has been deferred for future consultation.
9. The Commission suggests two forms of incentive regulation may be appropriate for the purpose of regulating GDBs, namely a total revenue-cap and a weighted average price-cap. GasNet supports the application of a weighted average price-cap that would allow a supplier to adjust its prices irrespective of volume, subject to an overall price-cap.
10. GasNet agrees with the Commission's view that it is appropriate to consider gas distribution and transmission as different types of services for the purposes of the initial DPP and to specify separate DPPs. However we note that GDBs do not have a relatively high degree of variable costs as suggested in the Issues Paper. GDBs price partly on a volumetric basis because gas is one of several energy forms available in a competitive market, not because their costs are highly variable.
11. While GDBs have an understanding of the drivers of future demand, their ability to influence demand is minimal. The demand a GDB faces for its services can be affected by unforeseen events such as climatic conditions, fluctuating demand from large end users, energy retailer behaviour and broader economic conditions.

Quantities

12. GasNet believes the price path should be specified using a form of allowable notional revenue measured as price times a defined quantity for that price. The base volume should reflect actual volumes with a t-2 lag.
13. GasNet supports a t-2 approach to lagging quantities for the price path as this will better achieve the objective of regulatory stability, and avoid costly and complicated adjustments which may be required were a t-1 approach adopted. GasNet acknowledges that a t-2 approach decreases the comparability between the assessment and actual quantities, but this additional 12 month lag is acceptable given the additional certainty it will provide for the DPP. This proposal also avoids additional compliance cost associated with potential disclosure (and audit) requirements for the reconciliation of estimated and actual quantities under a t-1 approach.

14. We note that this issue was debated at length for the electricity distribution DPP. Under a t-1 approach, complete data sets are not available when prices are set so forecasts must be used. This creates significant forecast risk in the DPP formula that can be mitigated with the adoption of a t-2 approach while ensuring quantities are broadly consistent with current tariff schedules, end-user demand and pricing approaches.

Inflation

15. GasNet supports a six-month lagged inflation option for the price path. This treatment of the inflation component of the price path is relatively simple to implement, accurately reflects underlying inflation, and prevents the need for an additional adjustment which would be required if inflation forecasts were used. This approach is consistent with the gas authorisation and the rationale for using a t-2 approach to quantities. It also contributes to the objective of regulatory certainty.

Pricing methodology

16. Under a weighted average price cap approach, GasNet will be able to rebalance tariffs across customer classes or introduce new tariffs if necessary during the course of the regulatory period, while not exceeding the overall price cap. This is reflective of GasNet's current business practices.
17. GasNet strongly supports the Commission's preliminary view that suppliers will not be required to apply the pricing methodology input methodology under the DPP. Such an approach will, as the Commission asserts, allow GDBs the flexibility to set and alter the structure of prices to apply during a regulatory period (e.g. to reflect business-specific circumstances) subject to the overall price cap.

Assessment

18. GasNet believes it is appropriate to set the price cap as allowable notional revenue and monitor performance using a notional revenue figure, where notional revenue is determined using prices for an assessment period multiplied by the relevant quantities.
19. Under the proposed t-2 approach there is no need for a reconciliation process because the use of lagged quantities will eliminate the problem of forecast and actual volumes diverging from each other.

Pass through costs

20. GasNet supports a mechanism that would protect the business against unforeseen movements in cost that are not in its control. Pass through costs for GasNet should include: statutory levies, local body rates and regulatory levies.
21. GasNet further submits that provision for a pass through of any costs associated with new legislation or regulation, or a legislative or regulatory change should be included in the initial DPP. GDBs should be able to apply for additional pass through costs prior to the beginning of the pricing year for approval by the Commission, consistent with the gas authorisation. An example of such a charge is a potential Gas Industry Company levy on regulated businesses.
22. Pass through costs should be set based on the anticipated level of these costs, with an adjustment factor to the following year's allowed revenue to account for any differences between the ex ante estimate and actual costs.

Re-openers

23. Under price cap regulation GasNet would be completely exposed to the consequences of external events that may impose significant costs on the business.
24. As previously submitted, GasNet considers re-openers are necessary for the DPP, as GDBs need the capability to respond to extreme events that affect the sector as a whole, or an individual GDB. The impact of such events would be immediate therefore the CPP process is not suitable to manage the impacts on the sector or individual firms.

Efficiency carry-over mechanisms

25. GasNet supports the adoption of efficiency carry-over mechanisms (ECMs) so that regulated firms are able to retain a given share of any benefits arising from efficiency gains for a defined period. ECMs incentivise firms to pursue efficiency savings by allowing companies to retain the benefit of any unexpected savings for the same period of time regardless of when in the regulatory cycle the savings are made.

26. In the absence of any such carryover mechanism, the nature of the broader regulatory framework means that companies would retain a greater share of the benefit of cost reductions made early in a regulatory period, rather than later. As a consequence the incentives firms face to make efficiency gains as they track through a regulatory period would weaken.

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

Yours sincerely

Geoff Evans

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