

# **Commerce Commission**

## Initial Default Price-Quality Paths for Gas Pipeline Businesses

### **Draft Reasons Paper**

21 November 2011



COMMERCE COMMISSION

Regulation Branch

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## GLOSSARY OF TERMS, ABBREVIATIONS AND DEFINITIONS

Abbreviation	Definition
Act, the	Commerce Act 1986
AMP	Asset Management Plan
April Discussion Paper	Refers to the Initial Default Price-Quality Path for Gas Pipeline Businesses Discussion Paper, 1 April 2011
August Discussion Paper	Refers to the Setting of Starting Prices for Gas Pipeline Businesses under the Initial Default Price-Quality Path Discussion Paper, 22 August 2011
Commission	Commerce Commission
CGPI	Capital Goods Price Index
CPI	Consumer Price Index
CPI Criterion	Tests whether weighted average price increases 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 on the date that the test is made
CPI-X	CPI minus an X-factor
CPP	Customised Price-Quality Path
DPP	Default Price-Quality Path
Draft Determinations	Refers to the Draft Gas Transmission Default Price-Quality Path Determination Pursuant to Part 4 of the Commerce Act 1986 and the Draft Gas Distribution Default Price-Quality Path Determination Pursuant to Part 4 of the Commerce Act 1986 that have been released for consultation at the same time as this Draft Reasons Paper
Draft Reasons Paper	Refers to <i>this</i> Draft Reasons Paper
EDBs	Electricity Distribution Businesses
Gas Authorisations	Refers to the Commerce Act (Powerco Natural Gas Services) Authorisation 2008; and Commerce Act (Vector Natural Gas Services) Authorisation 2008
GasNet	GasNet Limited
GDBs	Gas Distribution Businesses
GIC	Gas Industry Company Limited
GPBs	Gas Pipeline Businesses that include suppliers of gas distribution and gas transmission services

Abbreviation	Definition
GMS	Gas Measurement System as defined in the Gas Act 1992
GPS	Government Policy Statement
GTBs	Gas Transmission Businesses
GTIP	Gas Transmission Investment Programme
IMs	Refers to the Commerce Act (Gas Transmission Services Input Methodologies) Determination 2010, Decision No. 712; and the Commerce Act (Gas Distribution Services Input Methodologies) Determination 2010, Decision No. 711.
IM Draft Reasons	Refers to the Input Methodologies (Gas Pipeline Services) Draft Reasons Paper, 21 June 2010
IM Reasons	Refers to the Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper, 22 December 2010
Initial DPP	The initial default price-quality paths for GPBs that the Commission is required to set under s 55E(2) of the Act
IPP	Individual Price Quality Path (as applicable to Transpower)
Issues Paper	Refers to the Initial Default Price-Quality Path for Gas Pipeline Businesses Issues Paper, 12 April 2010
MDL	Maui Development Limited
MED	Ministry of Economic Development
MGUG	Major Gas Users Group
MPOC	Maui Pipeline Operating Code
Order, the	Commerce (Control of Natural Gas Services) Order 2005
Part 4 Purpose	Purpose of Part 4, as set out in s 52A of the Act
Powerco	Powerco Limited
RAB	Regulatory Asset Base
RIT	Regulatory Investment Test
RTE	Response Time to Emergency
Section 53K Purpose	Purpose of default/customised price-quality regulation, as set out in s 53K of the Act
Starting prices	Relates to price and/or revenue, consistent with s 53M(1)(a) and s 52C of the Act

Abbreviation	Definition
TFP	Total Factor Productivity
TRC	Total Revenue Cap
Vector	Vector Limited and any related parties as defined in the IMs
VTC	Vector Transmission Code
WAPC	Weighted Average Price Cap
X-factor	Under a CPI-X mechanism a regulated supplier may increase annual prices by no more than CPI, less a rate of change (i.e. the X-factor)

## EXECUTIVE SUMMARY

- X.1 The purpose of this Draft Reasons Paper is to provide reasons that underpin our Draft Determinations in setting default price-quality paths for suppliers of gas distribution and gas transmission services. To coincide with the release of this Draft Reasons Paper, we have also released the Draft Determinations for gas distribution businesses (GDBs) and gas transmission businesses (GTBs).<sup>1</sup>
- X.2 We seek feedback from all interested parties on the issues discussed in this Draft Reasons Paper and on the Draft Determinations. Submissions on these papers will be considered in setting the final determinations that will establish default price-quality paths for both GDBs and GTBs.
- X.3 Under section 55D of the Commerce Act 1986 (the Act), suppliers of gas pipeline services are to be subject to default/customised price-quality regulation.
- X.4 Under s 55E(2) of the Act, the Commerce Commission (Commission) is required to set initial default price-quality paths (Initial DPPs) for gas pipeline businesses (GPBs) as soon as practicable after 1 July 2010.
- X.5 Our overall approach to setting quality standards for GPBs has been to identify where such standards can better promote the Part 4 Purpose, without duplicating existing mechanisms that monitor and enforce safety and quality of gas pipelines. We intend that future information disclosure requirements will improve the transparency and availability of information across the gas sector that may be of use for determining additional quality standards at future resets.
- X.6 Our draft decision is that the current lack of robust historical information across the gas sector precludes the development of integrated price-quality paths for the Initial DPPs.<sup>2</sup>
- X.7 Our draft decision is that one quality standard, specifically response times to emergencies (RTEs), will apply to both GDBs and GTBs. All GPBs should demonstrate compliance with the quality standard for each year of the regulatory period. For GDBs, the quality standard will require 80% of all emergencies to be attended in no more than 60 minutes. For GDBs and GTBs, the quality standard will also require 100% of all emergencies to be attended in no more than three hours.

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<sup>1</sup> Commerce Commission, *Commerce Act (Gas Distribution Default Price-Quality Path) Draft Determination 2012*, 21 November 2011; Commerce Commission, *Commerce Act (Gas Transmission Default Price-Quality Path) Draft Determination 2012*, 21 November 2011.

<sup>2</sup> Section 53M(1)(b) of the Act requires every price-quality path to specify the quality standards that must be met by the regulated supplier. S 53M(2) states that for a supplier to maintain or improve its quality of supply, a price-quality path may incentivise this behaviour by including penalties (s 53M(2)(a)), rewards (s 53M(2)(b)), consumer compensation schemes (s 53M(2)(c)) and reporting requirements (s 53M(2)(d)). While not deciding on an integrated price-quality path for the Initial DPP, we consider that we can move towards an integrated price-quality path by using information disclosure reporting requirements to improve our data over time.

- X.8 We recognise that the recent disruption to the supply of gas on the Maui Pipeline was of great concern to industrial users, involved potential environmental damage and illustrated the significance of reliability of gas supply. The Ministry of Economic Development (MED) is leading an inquiry into this incident, and we will consider whether the findings of the inquiry indicate we should review quality standards for the suppliers of gas pipeline services.
- X.9 Our draft decision is that a weighted average price cap (WAPC) should apply to suppliers of gas distribution services in accordance with the input methodology applicable to gas distribution services. It is also our draft decision that a total revenue cap (TRC) should apply to suppliers of gas transmission services.
- X.10 Our draft decision is that the X-factor (the rate of change in real prices) for GPBs should be zero for the Initial DPPs since no conclusive evidence exists to support any other value for the X-factor.
- X.11 Our draft decision is that the regulatory period for the Initial DPP should start on 1 July 2012 and finish on 30 September 2016. This will enable suppliers to apply for a customised price-quality path (CPP). It also allows the option of claw-back to be applied, if prices are reset under s 55F(4). Neither of these options would be feasible until Initial DPPs have commenced.
- X.12 Prices under the Initial DPPs will be the same prices as those that applied at the end of the preceding regulatory period (i.e. a “rolling-over” of prices). A recent High Court judgment means that we cannot set starting prices based on a supplier’s current and projected profitability until additional input methodologies have been determined.
- X.13 Section 55F(2) requires the Commission to set the Initial DPPs as if 30 June 2010 was the end of the previous regulatory period. As such, starting prices for GTBs and those GDBs not currently subject to the Gas Authorisations will be their prices as at 30 June 2010, consistent with s53P(3)(a) and s 55F(1).<sup>3</sup>
- X.14 For those GDBs currently subject to the Gas Authorisations, under s55H(2) the expiry of the Order under which the Gas Authorisations are set must be treated as if it were the expiry of a CPP. Section 53X(2) requires that the starting prices are those that applied at the end of the CPP – i.e. the prices that applied at the expiry of the Gas Authorisations. As such, starting prices for those GDBs currently subject to the Gas Authorisations are their prices as at the expiry of the Gas Authorisations.
- X.15 Our draft decision is that claw-back under s 55F(2) should not be applied to GPBs for the Initial DPPs.
- X.16 Our Draft Determinations propose that the pricing and assessment periods of all GPBs should align to 1 October, with annual assessment periods of 1 October – 30

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<sup>3</sup>

The Gas Authorisations are as follows: Commerce Commission, *Decision 656: Authorisation – Powerco – Control of Supply of Natural Gas Distribution Services*, 30 October 2008; Commerce Commission, *Decision 657: Authorisation – Vector – Control of Supply of Natural Gas Distribution Services*, 30 October 2008.

September for each year of the regulatory period to align with the pricing years of GasNet, Powerco and Vector.

- X.17 To reduce the cost of compliance, assessment of the three-month period 1 July 2012 – 30 September 2012 will be combined with the assessment period for the first complete year of the Initial DPP (1 October 2012 – 30 September 2013), creating a 15 month assessment period. An *ex ante* compliance regime will be applied in regards to price, and an *ex post* compliance regime will be applied in regards to the quality standard.
- X.18 Following consideration of submissions on the matters discussed in this Draft Reasons Paper and the Draft Determinations that are due by 5pm, Monday 19 December 2011, we propose to publish our Final Determinations and Final Reasons Paper by 29 February 2012.

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## SECTION 1 INTRODUCTION

### Background

- 1.1 Under s 55D of the Commerce Act 1986 (the Act), all gas pipeline services are subject to default/customised price-quality regulation. Table 1.1 identifies businesses supplying gas pipeline services, as that term is defined in the Act, regulated under Part 4.<sup>4</sup>

**Table 1.1: Gas Pipeline Businesses (GPBs) subject to Part 4**

Gas Transmission Businesses (GTBs)	Gas Distribution Businesses (GDBs)
Maui Development Limited (MDL)	Powerco Limited (Powerco)
Vector Limited (Vector)	Vector
	GasNet Limited (GasNet)

- 1.2 Under s 55E(2) of the Act, the Commission is required to set initial default price-quality paths for GPBs (Initial DPP) as soon as practicable after 1 July 2010. We had originally proposed a start date of 1 July 2011 but, in response to submissions, we agreed that a start date of 1 July 2012 was more appropriate. We stated in October 2009 that we intended to set the Initial DPP by 1 July 2012 and provided our reasons for this approach.<sup>5</sup>
- 1.3 Under s 53O of the Act, a determination made under s 52P of the Act setting out a default price-quality path must contain certain information. This includes starting prices, rate(s) of change in prices and quality standards that apply during the regulatory period. The date on which a default price-quality path (DPP) takes effect, the annual dates by which any proposal for a customised price-quality path (CPP) must be received, and the dates by which compliance must be demonstrated in accordance with s 53N, must also be specified.<sup>6</sup>
- 1.4 We published the Input Methodologies (IMs) for gas pipeline services in December 2010 and these IMs bind us in setting the Initial DPP.<sup>7</sup>

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<sup>4</sup> Not all suppliers of gas pipeline services are subject to default/customised price-quality regulation. Exempt pipelines are listed under Schedule 6 of the Act.

<sup>5</sup> Commerce Commission, *Setting of the Default Price-Quality Path for Suppliers of Gas Pipeline Services Updated Process Paper*, 9 October 2009, paragraphs 6-10.

<sup>6</sup> CPP proposals under the Initial DPPs can be made in accordance with s 53Q of the Act.

<sup>7</sup> Commerce Commission, *Commerce Act (Gas Distribution Services Input Methodologies) Determination 2010*, 22 December 2010; Commerce Commission, *Commerce Act (Gas Transmission Services Input Methodologies) Determination 2010*, 22 December 2010; and Commerce Commission, *Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper*, 22 December 2010.

## Purpose

- 1.5 This Draft Reasons Paper provides the reasons for our Draft Determinations for the Initial DPPs for both GDBs and GTBs that are being released at the same time as this paper. This Draft Reasons Paper is relevant to both Draft Determinations.
- 1.6 For the avoidance of doubt, we will have regard to submissions received in relation to the draft GDB determination in considering the draft GTB determination, and vice versa.
- 1.7 We seek feedback from all interested parties on the issues discussed in this Draft Reasons Paper and on the Draft Determinations. Submissions will help us finalise our decisions on the Initial DPPs for GPBs.

## Scope of Issues

- 1.8 This Draft Reasons Paper is structured in a similar way to the April Discussion Paper for ease of reference:
- *Section 2 – Regulatory Framework:* sets out the regulatory framework under which we are required to set the Initial DPP for gas pipeline services
  - *Section 3 – Structure of the Default Price-Quality Path:* sets out our draft decision for establishing the structure of a DPP for gas pipeline services
  - *Section 4 – Quality Standards:* sets out our draft decision on the quality standards
  - *Section 5 – Form of Control:* sets out our draft decision on the forms of control for gas pipeline services
  - *Section 6 – Rate(s) of Change:* sets out our draft decision on the X-factor for gas pipeline services
  - *Section 7 – Price Under the Initial Default Price-Quality Path:* sets out our draft decision on how price should be determined for gas pipeline services
  - *Section 8 – Monitoring of Compliance:* sets out how compliance under the Initial DPP will be demonstrated and assessed.

## Previous Consultation

- 1.9 We have previously released a number of papers relevant to this Draft Reasons Paper and the Draft Determinations.

- an Issues Paper on the Initial DPPs for GPBs was released on 12 April 2010<sup>8</sup>
- a Draft Reasons Paper relating to input methodologies for GPBs was released on 21 June 2010<sup>9</sup>
- final input methodologies determinations that apply to GTBs and GDBs were released on 22 December 2010
- a discussion paper on the Initial DPPs was released on 1 April 2011 (April Discussion Paper)<sup>10</sup>
- a consultation paper on the proposed requirements for a s 53ZD information notice was released on 3 June 2011.<sup>11</sup> Formal information notice requests were then issued under s 53ZD of the Act to GPBs on 6 July 2011<sup>12</sup>
- a further discussion paper (August Discussion Paper) on the setting of starting prices for GPBs was released on 22 August 2011<sup>13</sup>

1.10 The above papers, and submissions to these papers, can be found on our website.<sup>14</sup> We have had regard to all submissions on these papers in making our draft decisions for GPBs, and Appendix A provides a high-level summary of how our decision making has evolved over time on key issues related to the setting of Initial DPPs for GPBs.

## Next Steps

1.11 Our next steps to determine the Initial DPP are set out in Table 1.2 below.

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<sup>8</sup> Commerce Commission, *Initial Default Price-Quality Path for Gas Pipeline Businesses*, 12 April 2010.

<sup>9</sup> Commerce Commission, *Input Methodologies Gas Pipeline Services Draft Reasons Paper*, 21 June 2010.

<sup>10</sup> Commerce Commission, *Initial Default Price-Quality Path for Gas Pipeline Businesses - April Discussion Paper*, 1 April 2011.

<sup>11</sup> Commerce Commission, *Default Price Quality Path for Gas Pipeline Businesses Draft Information Requests and Process Update Consultation Paper*, 3 June 2011.

<sup>12</sup> Section 53ZD Information Request Notices were issued to all GPBs subject to Part 4 regulation on 6 July 2011. These notices can be found on the Commission's website <http://www.comcom.govt.nz/2012-default-price-quality-path/>

<sup>13</sup> Commerce Commission, *Setting of Starting Prices for Gas Pipeline Businesses under the Initial Default Price-Quality Path*, 22 August 2011.

<sup>14</sup> <http://www.comcom.govt.nz/2012-default-price-quality-path/>

**Table 1.2: Proposed next steps for setting the Initial DPP**

Key Step	Indicative Date
Draft Reasons Paper and Draft Determinations	21 November 2011
Submissions due	19 December 2011
Cross-submissions due	20 January 2012
Final Reasons Paper and Final Determinations	29 February 2012

## Submissions

- 1.12 Submissions are invited on this Draft Reasons Paper and the Draft Determinations no later than **5pm Monday, 19 December 2011**. We also invite cross-submissions on matters raised in submissions to the Draft Reasons Paper and the Draft Determinations. The purpose of cross-submissions is to ensure that we are aware of points of agreement or disagreement on matters raised by other submitters. We therefore request that parties providing cross-submissions focus these in that way. Cross-submissions should be received by us no later than **5 pm Friday, 20 January 2012**. All submissions and cross-submissions should be supported by documentation and evidence, where appropriate. For the avoidance of doubt, we will have regard to all submissions and cross-submissions in making the Initial DPP for both GDBs and GTBs.
- 1.13 To foster an informed and transparent process, we intend to publish all submissions and cross-submissions on our website. Therefore, we request an electronic copy of each submission and hard copies of submissions not be provided (unless an electronic copy is not available). We also require that these electronic copies be provided in an accessible form (i.e. they are 'unlocked' and text can be easily transferred). If the submission contains confidential information or if the submitter wishes that the published version be 'locked', an additional document labelled "public version" should be provided.
- 1.14 Submissions should be sent to: [regulation.branch@comcom.govt.nz](mailto:regulation.branch@comcom.govt.nz);

or

Paul Mitchell  
 Chief Advisor  
 Regulation Branch  
 Commerce Commission  
 P.O. Box 2351  
 Wellington 6140

**Confidentiality**

- 1.15 We discourage requests for non-disclosure of submissions, in whole or in part, as it is desirable to test all information in a fully public way. We are unlikely to agree to any requests that submissions in their entirety remain confidential. However, we recognise that there will be cases where interested parties making submissions may wish to provide confidential information to us.
- 1.16 If it is necessary to include such material in a submission the information should be clearly marked and preferably included in an appendix to the submission. Interested parties should provide us with both confidential and public versions of their submissions. 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.
- 1.17 Parties can request that we make orders under s 100 of the Act in respect of information that should not be made public. Any request for a s 100 order must be made when the relevant information is supplied to us and must identify the reasons why the relevant information should not be made public. We will provide further information on s 100 orders if requested by parties, including the principles that are applied when considering requests for such orders. A key benefit of such orders is to enable confidential information to be shared with specified parties on a restricted basis for the purpose of making submissions. Any s 100 order will apply for a limited time only as specified in the order. Once an order expires, we will follow our usual process in response to any request for information under the Official Information Act 1982.

## SECTION 2 REGULATORY FRAMEWORK

### Overview

- 2.1 We determined IMs for GPBs on 22 December 2010. A detailed discussion of the regulatory context and purpose of Part 4 (Part 4 Purpose) was included within the IMs Reasons and is not replicated in full here.<sup>15</sup>
- 2.2 This section provides a brief summary of the relevant regulatory framework pertaining to GPBs as background.

### Part 4 Purpose

- 2.3 Section 52 of the Act provides an overview of Part 4:

This Part provides for the regulation of the price and quality of goods or services in markets where there is little or no competition and little or no likelihood of a substantial increase in competition.

- 2.4 Section 52A(1) of the Act states that the Part 4 Purpose 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; and
- (d) are limited in their ability to extract excessive profits.

- 2.5 As set out in the IM Reasons, our interpretation of the Part 4 Purpose is as follows:

- the central purpose is to promote the long-term benefit of consumers in markets where there is little or no competition and little or no likelihood of a substantial increase in competition
- this central purpose is to be achieved by promoting outcomes consistent with outcomes produced in workably competitive markets, such that the regulatory objectives set out in s 52A(1)(a)-(d) of the Act occur.<sup>16</sup>

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<sup>15</sup> Commerce Commission, *Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper*, 22 December 2010, pp. 16-53.

- 2.6 The regulatory instruments under Part 4, including the DPP, provide the mechanism through which we are to promote outcomes consistent with those produced in workably competitive markets.

### **Purpose of Default/Customised Price-Quality Regulation**

- 2.7 Section 53K of the Act provides that the purpose of default/customised price-quality regulation (Section 53K Purpose) is:

...to provide a relatively low-cost way of setting price-quality paths for suppliers of regulated goods or services, while allowing the opportunity for individual regulated suppliers to have alternative price-quality paths that better meet their particular circumstances.

- 2.8 We consider a DPP should be a generic tool, as far as possible, such that price-quality regulation can be cost-effectively applied across multiple suppliers. In developing our draft decisions, we have considered the Section 53K Purpose in addition to the Part 4 Purpose.
- 2.9 A DPP may not be able to fully reflect the particular circumstances of a supplier as its generic nature means that it is a comparatively non-targeted regulatory instrument. Setting starting prices for each individual supplier is the primary regulatory mechanism for making the price-related aspects of a DPP more specific to individual suppliers.
- 2.10 A DPP can employ supplier specific rates of change in particular circumstances and set starting prices based on the current and projected profitability of each supplier (subject to the recent High Court decision that requires the Commission to determine an additional IM). However, a DPP also makes some generic assumptions and projections for suppliers. This may mean that a DPP does not meet an individual supplier's particular circumstances. The regime provides for a CPP if those circumstances arise.
- 2.11 Part 4 of the Act therefore, specifically provides for regulated suppliers subject to default/customised price-quality regulation to be able to apply for a customised price-quality path (CPP) that better meets their particular circumstances.

### **Default/Customised Price-Quality Regulation and Input Methodologies**

- 2.12 We must apply the IMs that apply to GPBs in respect of the Initial DPP, but IMs do not inform every aspect of the Initial DPP determination. There are a number of decisions to be made in addition to those relating to the use of IMs, for instance in relation to the rates of change, quality standards, regulatory periods and compliance assessment periods.

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<sup>16</sup> Commerce Commission, *Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper*, 22 December 2010, paragraphs 2.4.2-2.4.3.

- 2.13 For the Initial DPPs, Parts 3 and 4 of the IMs apply to the suppliers of gas pipeline services.
- 2.14 Under s 55F(3), the Commission may set a DPP in respect of suppliers of gas pipeline services, even if all or any of the relevant IMs have not been determined.

### **Default price-quality path – key provisions**

- 2.15 Section 53O requires that a DPP must include the starting prices (as referred to in s53O(a)), rates of change (as referred to in s53O(b)), and quality standards (as referred to in s53O(c)) that apply to the supply of gas pipeline services for the regulatory period. It must also set out the date(s) on which the DPP takes effect, and the annual date by which a CPP must be received and compliance must be demonstrated in accordance with s53N.
- 2.16 Section 53M(1)(a) provides requirements for every price-quality path, including a DPP. These include either or both of the maximum price or prices that may be charged by a regulated supplier and the maximum revenues that may be recovered by a regulated supplier. We may include incentives for a supplier to maintain or improve quality of supply (refer s 53M(2)), with quality standards prescribed in whatever way we consider appropriate (refer s 53M(3)). A regulatory period is to be for five years (s 53M(4)), but can be reduced to as short as four years if we consider that would better meet the purposes of Part 4 (refer s 53M(5)).
- 2.17 Under s55F(1), the Commission must use the processes set out in s53P in making the first s52P determination that sets out how default price-quality regulation applies to suppliers of gas pipeline services. It must do this as if 30 June 2010 were the end of the previous regulatory period.
- 2.18 Under s53P(3), the starting prices must be either those that applied at the end of the preceding regulatory period, or prices based on the current and projected profitability of each supplier. Section 53P(6) requires the rate of change to be based on the long-run average productivity improvement rate achieved by either or both of suppliers of the relevant services in New Zealand, and suppliers in other comparable countries, using whatever measure of productivity the Commission considers appropriate.
- 2.19 Sections 55F(2) and (4) provide for claw-back to be applied in certain circumstances. Claw-back is discussed in Section 7 of this paper.

### **Other Statutory Considerations**

- 2.20 There are a number of additional considerations that we have had regard to when forming our draft decisions on the Initial DPP for GPBs. These include:

- the Gas Authorisations<sup>17</sup>
- decisions under the Gas Act 1992, as required under s 55I of the Act.

### **Gas Authorisations**

- 2.21 Under s 55G(2) of the Act, the Commerce (Control of Natural Gas Services) Order 2005 (the Order) continues in force, despite the repeal of (the old) Part 4, until the date on which the Order expires or is revoked. Section 55H(2) provides that the expiry of the Order must be treated as if it were the expiry of a CPP, and s53X applies.
- 2.22 Section 55G(3) of the Act confirms that the enactment of the new Part 4 does not limit or affect, before the expiry date, the Gas Authorisations, authorising the supply of controlled gas distribution services defined by the Order that are supplied by Powerco and Vector.

### **Gas Act**

- 2.23 Section 55I of the Act sets out provisions for interfacing the new Part 4 with the Gas Act 1992. Under s 55I, we are required to take into account, among other things, any gas governance regulation or rule made pursuant to Part 4A of the Gas Act, and any decision made under those regulations or rules, which relate to or affect quality standards or pricing methodologies for GTBs or GDBs.

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<sup>17</sup> Commerce Commission, *Decision 656: Authorisation – Powerco – Control of Supply of Natural Gas Distribution Services*, 30 October 2008; Commerce Commission, *Decision 657: Authorisation – Vector – Control of Supply of Natural Gas Distribution Services*, 30 October 2008.

## SECTION 3 STRUCTURE OF THE DEFAULT PRICE-QUALITY PATHS

### Commission's Draft Decision

- 3.1 Our draft decision is that gas distribution and transmission services are suitably defined in the IMs that apply to them, and the Initial DPPs will refer to these definitions.
- 3.2 It is also our draft decision is that the current lack of information on gas quality, reliability and safety precludes an integrated price-quality path and thus requires the development of separate price and quality paths for the Initial DPPs.<sup>18</sup>

### Nature and Scope of the Initial Default Price-Quality Paths

- 3.3 In the Issues Paper and the April Discussion Paper, we considered that gas distribution and transmission should be considered as different types of gas pipeline services that may require separate determinations under the Initial DPP. This would allow issues that are specific to each type of gas pipeline service to be addressed separately.<sup>19</sup>
- 3.4 This approach is consistent with the IMs for each type of gas pipeline service and parties that submitted on the April Discussion Paper expressed unanimous support for this view.<sup>20</sup>

### Differentiation of Distribution and Transmission Services

- 3.5 We previously considered that s 55A of the Act, with supporting definitions in the IMs, is sufficient for defining both gas transmission and gas distribution services.<sup>21</sup>

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<sup>18</sup> Section 53M(1)(b) of the Act requires every price-quality path to specify the quality standards that must be met by the regulated supplier. Section 53M(2) states that for a supplier to maintain or improve its quality of supply, a price-quality path may incentivise this behaviour by including penalties (s 53M(2)(a)), rewards (s 53M(2)(b)), consumer compensation schemes (s 53M(2)(c)) and reporting requirements (s 53M(2)(d)). By not deciding on an integrated price-quality path, we consider that rewards will not be applicable under the Initial DPPs as defined in s 53M(2)(b).

<sup>19</sup> Commerce Commission, *Initial Default Price-Quality Path for Gas Pipeline Businesses Issues Paper*, 12 April 2010, p.7, section 2; and Commerce Commission, *Initial Default Price-Quality Path for Gas Pipeline Businesses Discussion Paper*, 1 April 2011, p. 9, section 3.

<sup>20</sup> Vector, *Submission on Initial Default Price-Quality Path for Gas Pipeline Businesses: Discussion Paper*, 27 May 2011, p.28, paragraph 133; MDL, *Submission on Initial Default Price-Quality Path for Gas Pipeline Businesses: Discussion Paper*, 27 May 2011, p.3, paragraph 2.1; Powerco, *Submission on Initial Default Price-Quality Path for Gas Pipeline Businesses: Discussion Paper*, 27 May 2011, p.3 paragraph 3; GasNet, *Submission on Initial Default Price-Quality Path for Gas Pipeline Businesses: Discussion Paper*, 27 May 2011, p.2, paragraph 6.

<sup>21</sup> Commerce Commission, *Initial Default Price-Quality Path for Gas Pipeline Businesses Discussion Paper*, 1 April 2011, Section 3.

3.6 Under the IMs, both gas transmission and gas distribution services are defined as meaning any gas pipeline services (as defined in s 55A of the Act) supplied across a network, with “network” being defined differently for each type of service.

3.7 The gas transmission IM defines the relevant network as:<sup>22</sup>

...the high pressure transmission pipeline systems under the control of one person between the place where gas enters those transmission pipeline systems (commonly referred to as a 'receipt point') and the place where gas exits them, provided that where the place of exit is a delivery point to a distribution network owned by the same person who owns the transmission pipeline system in question, the delivery point is the place specified by that person

and where “person” has the same meaning as defined in s 2 of the Act.<sup>23</sup>

3.8 For gas distribution services, the IM defines the relevant network as:<sup>24</sup>

...the system used to distribute gas to a consumer, comprising pipelines and associated fittings between-

(a) a delivery point from a transmission network; and

(b) the point of supply, provided that where the pipelines and associated fittings are owned by the same person who owns the relevant transmission network, the delivery point is the place specified by that person

and where the terms “consumer” and “fittings” have the same meanings as defined in s 2(1) of the Gas Act 1992, and a “point of supply” has the same meaning as specified in regulation 5 of the Gas (Safety and Measurement) Regulations 2010.

3.9 GasNet and Vector largely agreed with the policy intent of the definitions but believed that the definitions, as drafted, left some ambiguity. Vector proposed alternative definitions.<sup>25</sup>

3.10 Vector also argued that the ‘delivery point’ and the ‘receipt point’ on a transmission network are not defined. It considers the non-definition of a delivery point on the transmission network has flow-on implications for the definition of a distribution network.

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<sup>22</sup> Commerce Commission, *Commerce Act (Gas Transmission Services Input Methodologies) Determination 2010*, 22 December 2010, p. 15.

<sup>23</sup> Section 2 of the Act defines a person as being the following: “Person – includes a local authority, and any association of persons whether incorporated or not.”

<sup>24</sup> Commerce Commission, *Commerce Act (Gas Distribution Services Input Methodologies) Determination 2010*, 22 December 2010, p. 15.

<sup>25</sup> Vector Limited, *Submission on Initial Default Price-Quality Path for Gas Pipeline Businesses: Discussion Paper*, 27 May 2011, p.29-30, paragraph 134-143; GasNet, *Submission on Initial Default Price-Quality Path for Gas Pipeline Businesses: Discussion Paper*, 27 May 2011, p.2-3, paragraphs 7-12.

- 3.11 We note and appreciate the general intent of Vector's submission; i.e. to ensure greater specificity in the definitions of gas distribution and gas transmission networks. However, in this instance, we consider that the relatively non-prescriptive definition of 'delivery point' and 'receipt point' between gas distribution and transmission networks is justified as ownership arrangements between separate distribution and transmission parties will naturally define where this demarcation should be. As we are not privy to these ownership arrangements, we do not want to impose a level of specificity on the precise demarcation point (between receipt point and delivery point) as this may impose an inappropriate definition for the two affected parties.<sup>26</sup>
- 3.12 Where the point of delivery and the receipt point affect the same company or a related party, we consider that it is most efficient to allow the company or related party in question to determine the demarcation point, providing this separation is consistent and does not result in the duplication of assets as being both transmission and distribution assets.
- 3.13 Provided that parties do not double-count assets in their Regulatory Asset Bases (RABs), we consider that allowing the parties to identify the boundaries of transmission and distribution networks will not be problematic and will minimise compliance costs.
- 3.14 As the Act excludes meter services in the definition of gas pipeline services, our draft decision is that a gas distribution network is clearly defined in the IMs as everything (from the 'point of delivery' from the transmission network) up to the gas measurement system (GMS) outlet point, less the GMS itself.
- 3.15 Vector also submitted on the definition of what constitutes a 'person' in the definition of transmission and distribution assets, and specifically, whether related companies are captured by this definition.<sup>27</sup> This is relevant for Vector because the Auckland gas distribution network is owned by Vector Limited and Vector's gas transmission network and North Island gas distribution network are owned by Vector Gas Limited.
- 3.16 Vector contends that 'person' does not include related companies, and therefore, Vector asserts that these definitions would only apply in respect of the non-Auckland distribution/transmission relationship.
- 3.17 The proviso in the definition of network in the IM is only of relevance where the transmission and distribution networks are owned by the same person.
- 3.18 We also note that Vector should ordinarily be able to determine the appropriate demarcation point, either through the ownership arrangements

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<sup>26</sup> For the purposes of this paper, 'delivery point' is in relation to a gas transmission delivery point and 'receipt point' is in relation to a gas distribution receipt point.

<sup>27</sup> Vector, *Submission on Initial Default Price-Quality Path for Gas Pipeline Businesses: Discussion Paper*, 27 May 2011, p.29-30, paragraphs 140-143.

that have been determined between Vector Limited and Vector Gas Limited, or at the discretion of Vector.<sup>28</sup>

### **Integrated versus Separate Price-Quality Paths**

- 3.19 Our draft decision is that the Initial DPP should consist of separate price paths and quality standards.
- 3.20 Section 53O sets out what a s 52P determination must include for a DPP. The list includes, amongst other things, the starting prices that apply to the supply of goods and services during the first regulatory period (s 53O(a)) and the quality standards that apply during the first regulatory period (s 53O(c)). The Act does not, however, prescribe how these price and quality dimensions are to be incorporated under a DPP.
- 3.21 An integrated path approach is possible under the Act, because the Act allows us to set financial incentives for a supplier to maintain or improve its quality of supply. Specifically, s 53M(2)(b) states that:
- A price-quality path may include incentives for an individual supplier to maintain or improve its quality of supply, and those incentives may include (without limitation) rewards by way of an increase in the supplier’s maximum prices or revenue based on whether, or by what amount, the supplier meets or exceeds the required quality standards
- 3.22 An “S-factor” is a form of incentive mechanism used in some overseas jurisdictions that allows a supplier’s pricing allowance to adjust to reflect changes in their quality performance.<sup>29</sup> We had previously sought views from interested parties on the relevance of an S-factor approach for GPBs as part of its Regulatory Provisions Paper.<sup>30</sup>
- 3.23 The Act does not prevent separate price paths and quality standards being specified. Non-compliance with either the price-path or quality standards would be considered a breach of the Initial DPP. This approach was adopted for the EDB DPP.<sup>31</sup>

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<sup>28</sup> We consider that this in-principle position would not just apply to Vector but would remain the same should another party own and operate transmission and distribution network assets.

<sup>29</sup> Under an incentive-based CPI-X price control, an “S-factor” involves an adjustment to the supplier’s maximum prices or revenues, such that a supplier is provided explicit incentives to improve (and in some cases reduce) quality. This is because, as shown below in this footnote, it is separate to the X-factor. That is, the S-factor captures a relationship between an improvement in service quality and an increase in price that the supplier may be allowed as an incentive (or as compensation for the costs incurred) to improve service quality. The S-factor is generally represented by a separate variable in the CPI-X formula—i.e., CPI-X+S.

<sup>30</sup> Commerce Commission, *Regulatory Provisions of the Commerce Act 1986, Discussion Paper*, 19 December 2008, p.137.

<sup>31</sup> Commerce Commission, *Initial Reset of the Default Price-Quality Path for Electricity Distribution Businesses*, 30 November 2009, p. 19, paragraphs 3.11-3.14.

- 3.24 Our initial position was that the Initial DPP should consist of price paths that are specified and assessed separately from quality standards because of the limited robust historical data available across the gas sector.<sup>32</sup>
- 3.25 GPBs were generally supportive of our approach and were cautious of the practical implications of establishing an incentive mechanism for the Initial DPP.<sup>33</sup>
- 3.26 An important consideration for successfully implementing an integrated price-quality path is the ability to determine the relationship between the marginal value of quality and the level of any price/revenue incentive term. We noted that the lack of information on the value that consumers place on reliability and their willingness to make price/quality trade-offs would make the specification of incentive levels potentially arbitrary and not necessarily efficient.<sup>34</sup>
- 3.27 Our approach, while appropriate in the short term, may be improved on over time. We intend to take a long-term perspective in determining the structure of the DPP by gathering information throughout the Initial DPP on a range of quality indicators that will enable us to consider the merits of an integrated price-quality path at subsequent resets.
- 3.28 We propose to issue draft information disclosure requirements for GPBs in December 2011, that will be consistent with the IMs. Submissions on the draft information disclosure requirements will be due in February 2012.<sup>35</sup>
- 3.29 The future provision of information by GPBs will enable us to build a better picture of performance across the sector. This will inform future decisions about integrated and separate price-quality paths.
- 3.30 We will now discuss the reasons for our draft decisions on quality standards under the Initial DPP. This will be followed by the reasoning for our draft decisions on the components of price under the Initial DPP.

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<sup>32</sup> Commerce Commission, *Initial Default Price-Quality Path for Gas Pipeline Businesses Discussion Paper*, 1 April 2011, paragraphs 3.20-3.23.

<sup>33</sup> GasNet, *Submission on Initial Default Price-Quality Path for Gas Pipeline Businesses: Discussion Paper*, 27 May 2011, p.2-3, paragraphs 7-12; Vector Limited, *Submission on Initial Default Price-Quality Path for Gas Pipeline Businesses: Discussion Paper*, 27 May 2011, p. 30-31, paragraphs 144-145; Vector Limited, *Regulatory Provisions of the Commerce Act 1986, Response to Discussion Paper*, 16 February 2009, p.38; MDL, *Submission on Initial Default Price-Quality Path for Gas Pipeline Businesses: Discussion Paper*, 27 May 2011, p.3, paragraph 2.3 and Powerco, *Submission on Initial Default Price-Quality Path for Gas Pipeline Businesses: Discussion Paper*, 27 May 2011, p.3 paragraph 3

<sup>34</sup> Commerce Commission, *Initial Reset of the Default Price-Quality Path for Electricity Distribution Businesses*, 30 November 2009, p. 19, paragraphs 3.11-3.14

<sup>35</sup> Draft reasons papers will accompany the release of the draft information disclosure determinations. Our intention remains that the final information disclosure determinations will apply in respect of the 2012/2013 disclosure year.

## SECTION 4 QUALITY STANDARDS

### Commission's Draft Decision

- 4.1 Our draft decision is that one quality standard, specifically response times to emergencies (RTEs), will apply to both GDBs and GTBs for the Initial DPP.
- 4.2 Our draft decision is that different standards should apply to GDBs and GTBs for measuring performance against this standard. The standards that will apply to GDBs and GTBs are shown in Table 4.1 below, and we have decided to base these on our previous view in the April Discussion Paper.<sup>36</sup>

**Table 4.1 Quality Standards for GPBs**

Quality Standard	Definition/Calculation	Standard to be met
Response Time to Emergencies	Emergency response times.	80% of responses in no more than 60 minutes (applicable to GDBs only)
	<p>'Emergency' means an incident for which one of the emergency services (i.e.: fire service, ambulance, police) is called and which is reported to the GPB; or an unplanned disruption in the supply of gas that affects more than five customers; or the need to evacuate premises as the result of escape or ignition of gas.</p> <p>'Response Time' means the time elapsed from when an emergency is reported to a GPB representative until a GPB's personnel arrive at the location of the emergency.</p>	100% of responses in no more than 180 minutes (applicable to GTBs and GDBs)

- 4.3 Our draft decision is that all GPBs should demonstrate compliance with the above quality standard for each year of the Initial DPP regulatory period.

<sup>36</sup>

Commerce Commission, *Initial Default Price-Quality Path for Gas Pipeline Businesses Discussion Paper*, 1 April 2011, paragraph 7.32.

## Quality Standards - Framework

- 4.4 Section 53M(1)(b) of the Act provides that the Initial DPP must specify the quality standards to be met by each regulated supplier.
- 4.5 Setting quality standards helps to ensure that the service quality that consumers receive is not compromised by efforts to reduce costs, and consequently, helps to meet the Part 4 Purpose; most notably the requirement of s 52A(1)(b) of the Act.
- 4.6 The presence of quality standards in the Initial DPP is also consistent with regulatory approaches taken in other jurisdictions, where regulators seek to ensure that reductions in expenditure by distributors are not achieved to the detriment of quality standards.<sup>37</sup>
- 4.7 Section 53M(3) of the Act states that quality standards for the Initial DPP:  
 ...may be prescribed in any way the Commission considers appropriate<sup>38</sup>
- 4.8 Thus, while the Act is not specific about how we should address quality standards, s 53M(3) explicitly contemplates targets, bands and formulae.
- 4.9 Section 55I(2) requires that before we exercise any of our powers under Part 4, we take into account regulations and rules under the Gas Act 1992 (or any decision under those regulations or rules) that relates to quality standards or pricing methodologies and are applicable to the pipeline owner.
- 4.10 For example, in reaching our draft decision on quality standards for GPBs, we are required to have regard to the requirements of certain rules and regulations that are administered by the Gas Industry Company Limited (GIC).<sup>39</sup>
- 4.11 Under s 55I(1) the GIC is obliged to advise us of any recommendation for a gas governance regulation or rule under Part 4A of the Gas Act 1992(or any decision under those regulations or rules) that is likely to be relevant to our powers under Part 4 (of the Commerce Act). To date, we have not received any notification from GIC under s 55I of matters that we need to take into account.

## Our Approach to the Setting of Quality Standards for Gas Pipeline Businesses

- 4.12 Our overall approach to setting quality standards for GPBs has been to identify where such standards can better promote the Part 4 Purpose, without

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<sup>37</sup> One such example is: Essential Services Commission, *Final Decision, Electricity Distribution Price Review 2006-10, Final Decision Volume 1, Statement of Purpose and Reasons*, 19 October 2005, p. 23.

<sup>38</sup> s 53M(1)(b) and (3)

<sup>39</sup> This includes the *Gas Governance (Critical Contingency Management) Regulations 2008*, the *Gas (Switching Arrangements) Rules 2008* and the *Gas (Downstream Reconciliation) Rules 2008*.

duplicating existing mechanisms. We have also recognised that some GPBs have not been required to record, monitor and provide data for measuring quality in the past, and have allowed for the limitations this has presented to us in setting appropriate standards for the Initial DPP.

- 4.13 We note that ensuring network quality for consumers of gas pipeline services is not solely our responsibility. Several mechanisms already contribute to the provision of a safe and reliable supply of gas in New Zealand.
- 4.14 Appendix B provides an overview of the current legislation and regulations relating to safety and the standards applicable to the operation of gas distribution and transmission pipelines.
- 4.15 We note that in addition to existing safety regulations, existing contractual arrangements are also relevant to the allocation of responsibility for gas pipeline issues. This includes the Maui Pipeline Operating Code (MPOC), Vector Transmission Code (VTC).<sup>40</sup> The GIC is also currently evaluating distribution arrangements for GDBs, and this work is ongoing.<sup>41</sup>
- 4.16 There are also existing regulations, in the form of the *Gas Governance (Critical Contingency Management) Regulations 2008*, that govern the curtailment and restoration of gas supplies in the event of a major incident involving the supply of gas through pipelines.<sup>42</sup> The recent Maui pipeline incident illustrated the ability of these regulations to safeguard supplies to essential users.<sup>43</sup>
- 4.17 We recognise that the recent disruption to the supply of gas on the Maui Pipeline was of great concern to industrial users, involved potential environmental damage and illustrated the significance of the reliability of gas supply. Until the MED inquiry into the causes of, and response to, this disruption is completed, we will not be in a position to determine the implications for our role as regards quality standards. Thus, we consider that it

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<sup>40</sup> The MPOC can be found at: <http://www.mauipipeline.co.nz/uploads/docs/board/MPOC%20as%20at%2001%20February%202010.pdf> , the VTC can be found at: <https://www.oatis.co.nz/Ngc.Oatis.UI.Web.Internet/Common/Publications.aspx> , and GIC's current work programme on developing model standard contract terms for GDBs can be found at: [http://gasindustry.co.nz/sites/default/files/consultations/12/Options\\_for\\_the\\_Governance\\_of\\_Retail\\_Contract\\_Terms\\_and\\_Conditions\\_151323.5\\_1.pdf](http://gasindustry.co.nz/sites/default/files/consultations/12/Options_for_the_Governance_of_Retail_Contract_Terms_and_Conditions_151323.5_1.pdf)

<sup>41</sup> GIC's latest work in this area can be viewed at: [http://gasindustry.co.nz/sites/default/files/consultations/254/discussion\\_paper\\_on\\_the\\_draft\\_principles\\_for\\_arrangements\\_on\\_gas\\_distribution\\_systems\\_169651.4\\_0.pdf](http://gasindustry.co.nz/sites/default/files/consultations/254/discussion_paper_on_the_draft_principles_for_arrangements_on_gas_distribution_systems_169651.4_0.pdf)

<sup>42</sup> A useful guide to the *Gas Governance (Critical Contingency Management) Regulations 2008* can be found on GIC's website at: [http://gasindustry.co.nz/sites/default/files/publications/ccm\\_faq\\_for\\_website\\_-\\_oct\\_2011\\_175363.1.pdf](http://gasindustry.co.nz/sites/default/files/publications/ccm_faq_for_website_-_oct_2011_175363.1.pdf)

<sup>43</sup> A copy of the Maui pipeline incident report of 4 November 2011 can be found at: <https://www.oatis.co.nz/Ngc.Oatis.UI.Web.Internet/Common/Publications.aspx>

is neither appropriate nor feasible to include a security of supply measure reflecting the quality of service consumers demand, in the quality standards for the first regulatory period. When the results of the MED inquiry become available, we will consider whether we should review quality standards for the suppliers of gas pipeline services.

- 4.18 In response to our April Discussion Paper, no submitters disagreed with our rationale for setting quality standards under the Initial DPPs. However, there was no consensus among parties as to the appropriate approach for setting and assessing quality standards.<sup>44</sup>
- 4.19 Vector supported the use of RTE (with a threshold) as a quality standard for the initial regulatory period for GDBs.<sup>45</sup>
- 4.20 In cross-submissions to the April Discussion Paper, MDL supported Vector's proposal for location-based compliance thresholds for RTEs.<sup>46</sup>
- 4.21 Vector recommended that we consider assessing compliance over a multi-year period, given that the number of emergencies on the gas transmission system is much lower than on the distribution system (approximately ten per year on average). Vector argued that assessing compliance over an entire regulatory period rather than annually would be statistically more meaningful.<sup>47</sup>
- 4.22 Both Powerco and Vector suggested that it would be more appropriate to redefine a breach to be a failure to meet the standard in two out of three years, in the same manner as quality measures are treated in the DPP for EDBs.<sup>48</sup>
- 4.23 Powerco and Vector also supported collecting data based on average response times, as this may be a better measure of performance over time. Vector asserts that this approach would incentivise GPBs to improve response times on every emergency event, not just those for which it may take approximately sixty minutes to reach the site.<sup>49</sup>

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<sup>44</sup> For instance, MGUG explicitly supported this approach to setting quality requirements. MGUG, *Submission on Initial Default Price-Quality Path for Gas Pipeline Businesses*, 27 May 2011, section 8.

<sup>45</sup> Vector, *Submission on Initial Default Price-Quality Path for Gas Pipeline Businesses: Discussion Paper*, 27 May 2011, paragraph 68, p.16.

<sup>46</sup> MDL, *Cross-Submission on Initial Default Price-Quality Path for Gas Pipeline Businesses: Discussion Paper*, 10 June 2011, p.1.

<sup>47</sup> Vector, *Submission on Initial Default Price-Quality Path for Gas Pipeline Businesses: Discussion Paper*, 27 May 2011, paragraph 87 p.19.

<sup>48</sup> Vector, *Submission on Initial Default Price-Quality Path for Gas Pipeline Businesses: Discussion Paper*, 27 May 2011, paragraph 55, p.13 and Powerco, *Submission on Initial Default Price-Quality Path for Gas Pipeline Businesses: Discussion Paper*, 27 May 2011, paragraph 20, p. 6.

<sup>49</sup> Vector, *Submission on Initial Default Price-Quality Path for Gas Pipeline Businesses: Discussion Paper*, 27 May 2011, paragraph 56, p.13 and Powerco, *Submission on Initial Default Price-Quality Path for Gas Pipeline Businesses: Discussion Paper*, 27 May 2011, paragraph 21, p. 6.

- 4.24 We agree that the information may be useful but are not in favour of using average response times as a quality standard, because averages may hide some neglected areas and we do not have adequate data to set a standard.
- 4.25 The way in which we have defined the quality standard in our draft decisions provides for both GTBs and GDBs to respond to emergencies in a timely manner, even in the event of unfavourable circumstances (such as geographical distance and geological conditions).
- 4.26 The lower limit of an 80% emergency response rate in no more than 60 minutes was proposed by Vector, and we believe that, in the absence of any robust historical data, this represents a reasonable 'lower limit' for GDBs.<sup>50</sup>
- 4.27 We propose to introduce an upper limit to the quality standard, namely that a representative of the GDB or GTB should reach the location of all emergencies in no more than 180 minutes. It is our view that personnel should be able to reach an emergency site within three hours, regardless of the location, event or type of emergency.
- 4.28 We have decided to set an upper limit because without one, there may be a reduced incentive on a pipeline operator to attend to an event promptly if it has taken, or will likely take, longer than 60 minutes to reach the site of the emergency. We believe the setting of an upper limit better promotes the Part 4 Purpose, in particular s 52A(1)(b).
- 4.29 If a GPB does not meet the standards prescribed in any given year, then we will require that supplier to provide us with further information explaining:
- the effect of specific incidents on meeting the quality standard
  - the location of such incidents
  - a description of the incidents, including their nature and cause
  - the number of consumers affected.
- 4.30 The provision of this information will help us assess the nature of any non-compliance and inform our decisions for dealing with that non-compliance.
- 4.31 We agree with Powerco and Vector that maintaining service quality over time is likely to be a reasonable reflection of consumer preferences, and on that basis, is consistent with section 52A(1)(b). We considered whether assessment of quality standards should take place across a number of years, given that inadequate performance in a single year may not indicate an underlying trend of deteriorating performance.

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<sup>50</sup> Vector, *Submission on Initial Default Price-Quality Path for Gas Pipeline Businesses: Discussion Paper*, 27 May 2011, paragraph 71, p.16.

- 4.32 However, we consider the requirement for all GPBs to comply with the quality standard for each year of the Initial DPP regulatory period (and explain non-compliance) is not unreasonable.
- 4.33 The quality standard included in our draft decision has a built-in mechanism (namely an 80% and a 100% response time) that will accommodate extenuating circumstances.

### **Response Times to Emergencies - Definition**

- 4.34 Powerco recommended that the definition of an ‘emergency’ be amended to allow for instances when the emergency services are in attendance, but the presence of a GDB engineer is not required. Powerco specifically suggested that the following definition is employed:

An emergency would be defined as an incident for which one of the emergency services (police, fire service, etc.) is called and deems the immediate attendance of a gas distribution business engineer is required<sup>51</sup>

- 4.35 MDL was also of the opinion that:

...the definition of emergency requires consideration to ensure that it is not too broad, covering situations where emergency services are called as a precautionary strategy rather than because they were needed<sup>52</sup>

- 4.36 We have decided that the definition provided in the Gas Authorisations is sufficient for the purposes of the Initial DPP. This is provided in Table 4.1. Furthermore, those GPBs that are currently subject to the Gas Authorisations have familiarity of reporting against these standards and further definitional changes could result in further ambiguity.

### **Auditing of the Quality Standard**

- 4.37 We acknowledge the reporting and auditing of quality standards will likely impose additional costs on GPBs, especially for auditing. In addition, GPBs may have to change internal and external information collection and auditing processes to meet these requirements. However, we remain of the view that the provision of audited information on the quality standard is necessary to ensure the legitimacy of data presented, and hence, is crucial to better promoting the Part 4 Purpose. We must be able to trust the data that is being presented as it will ultimately be used to assess compliance against the DPP in the regulatory period.

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<sup>51</sup> Powerco, *Submission on Initial Default Price-Quality Path for Gas Pipeline Businesses: Discussion Paper*, 27 May 2011, paragraph 23, p. 7.

<sup>52</sup> MDL, *Submission on Initial Default Price-Quality Path for Gas Pipeline Businesses: Discussion Paper*, 27 May 2011, paragraph 8.3.5, p.9.

## **Regional Disaggregation**

- 4.38 Vector stated in its submission that if quality standards for GDBs are broken down into non-contiguous networks then the probability of breaching the standards due to one unusual event (eg delays caused by heavy traffic) could be much higher. Vector recommends that, even if quality is reported at a non-contiguous level, the standard(s) should apply to the gas distribution network as a single entity.
- 4.39 We agree with this approach and do not consider that the regional disaggregation and reporting of quality standards should be required under the Initial DPP.

## SECTION 5 FORM OF CONTROL

### Commission's Draft Decision

- 5.1 The IMs require that we apply a weighted average price cap (WAPC) to suppliers of gas distribution services.
- 5.2 Our draft decision is to apply a Total Revenue Cap (TRC) to the supply of gas transmission services by both MDL and Vector.

### Form of Control for Gas Distribution Businesses

- 5.3 Clause 3.1.1(1) of the IMs specifies that prices charged by a GDB will be specified in a s 52P determination as a WAPC applying to the GDB for that regulatory period.

### Form of Control for Gas Transmission Businesses

- 5.4 The IMs specify that either a WAPC or a TRC must apply to GTBs. When determining whether a TRC or a WAPC should be applied in respect of a particular GTB, the IMs Reasons noted that this decision will be a matter of judgement on our part after considering the criteria in the IMs.<sup>53</sup>
- 5.5 We have decided that applying a TRC to the existing GTBs would better meet the Part 4 Purpose. In particular, we consider it will provide stronger incentives to GTBs to innovate and invest (s 52A(1)(a)) and provides services at a quality that better reflects consumers demands (s 52A(1)(b)).

### Catering for Future Investment Needs of Gas Transmission Businesses

- 5.6 We are aware that GTBs consider the Initial DPP should specifically cater for significant network investments, and that making a CPP application for this purpose is undesirable.<sup>54</sup>
- 5.7 We, however, do not think that modifying the DPP to cater for significant network investment is consistent with the low cost and generic nature of the DPP.
- 5.8 As we have discussed above, we have amended our view on the form of control that will apply to GTBs and in response to Vector's view that a TRC will incentivise investment by ensuring that a GTB's revenue requirements will be met. We have amended of view mindful of s 52A(1)(a) of the Act.

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<sup>53</sup> Commerce Commission, *Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper*, 22 December 2010, p.191, paragraph 8.3.3.

<sup>54</sup> MDL, *Commerce Commission Submission: Initial Default Price-Quality Path for Gas Pipeline Businesses*, 27 May 2011, section 6, page 4 & Vector Limited, *Submission to the Commerce Commission on Gas Transmission Form of Control and Investment*, 27 May 2011.

- 5.9 We consider that the proposed form of control and the option of applying for a CPP provide sufficient flexibility to cater for the specific circumstances of GDBs and GTBs. We note that the CPP IM allows for uncertain or unforeseen gas transmission investments by adopting a contingent/unforeseen project approach.<sup>55</sup>
- 5.10 We are also aware that GIC has recently consulted on a Gas Transmission Investment Programme (GTIP) as part of its ongoing work programme.<sup>56</sup> We understand the purpose of the GTIP is to respond to industry concerns over the long-term outlook for gas transmission capacity availability in the Auckland region. The objective of the GTIP is to:
- ensure that existing and future gas transmission assets are used efficiently
  - establish whether there is a need for gas transmission investment
  - develop an effective pathway for efficient gas transmission investment to take place.
- 5.11 We consider that the GTIP offers the opportunity for GTBs to work with GIC in defining what the future investment needs of GTBs may be in the longer term.
- 5.12 We remain supportive of GIC's work to progress the GTIP, particularly where this better enables the performance of the statutory functions of both GIC and ourselves in the longer term.

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<sup>55</sup> Commerce Commission, *Commerce Act (Gas Transmission Services Input Methodologies) Determination 2010*, 22 December 2010, clause 5.7.3.

<sup>56</sup> Refer to GIC's website <http://gasindustry.co.nz/work-programme/gas-transmission-investment-programme>

## SECTION 6 RATE(S) OF CHANGE

### Commission's Draft Decision

- 6.1 Our draft decision is to use a value of X=0 for the Initial DPPs, since no conclusive evidence exists to support any other value for the X-factor.<sup>57</sup>

### Rate(s) of Change – Regulatory Context

- 6.2 Section 53P(1) of the Act requires that we set out the rate of change that applies to suppliers for the Initial DPP. Section 53P(1) states:

Before the end of the first and every subsequent regulatory period, the Commission must amend the section 52P determination by setting out the starting prices (as referred to in section 53O(a)), rates of change (as referred to in section 53O(b)), and quality standards (as referred to in section 53O(c)) that apply for the following regulatory period.

- 6.3 Section 53P(5) of the Act states that we must set only one rate of change for GPBs.

Subject to subsection (8), the Commission must set only one rate of change per type of regulated goods or services (for example, if the rate of change (X) is 1% in a CPI-X path, 1% must be the rate for all goods and services of that type).

- 6.4 A single X-factor will apply for each regulated service, although we may set alternative rates of change for individual suppliers in certain circumstances.<sup>58</sup>

- 6.5 As contemplated in s 53P(3), we have adopted the term “X-factor” to represent the “X” component of the CPI-X indexation component of the price path. The X-factor limits the maximum amount (relative to the CPI) by which GPBs are permitted to increase their weighted average price or revenue each year.

- 6.6 Section 53P(6) of the Act specifies that the X-factor for regulated suppliers under a DPP is to be:

...based on the **long run average productivity improvement rate** achieved by either or both of the suppliers in New Zealand, and suppliers in other comparable countries, of the relevant goods or services, using whatever measures of productivity the Commission considers appropriate. [emphasis added].

- 6.7 The setting of the X-factor, which is representative of the long run average productivity improvement rate in the sector, is consistent with s 52A(1)(b)) as it incentivises GPBs to achieve any efficiencies made over and above those implicit in the CPI-X price path.

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<sup>57</sup> We are able to set alternative rates of change for a particular supplier in specific circumstances under s 53P(8).

<sup>58</sup> Sections 53P(5) and (8) of the Act.

6.8 The Act explicitly provides that we may use whichever measures of productivity we consider appropriate to set the X-factor. Several methods for measuring productivity growth rates have been contemplated:

- undertaking a New Zealand productivity analysis (similar to the approach used for the EDB DPP)
- using overseas gas sector productivity growth estimates
- using information from other sectors of the economy (i.e. consider the productivity of the New Zealand gas sector against other regulated sectors or the economy as a whole).

### **Economic Insights' Conclusions**

- 6.9 We commissioned Economic Insights to assess whether there is robust evidence to suggest that the long-run productivity growth rate of New Zealand GTBs and GDBs is significantly different from that of the New Zealand economy as a whole.<sup>59</sup> Economic Insights also examined available evidence on whether input price growth for New Zealand GPBs is significantly different to that for the New Zealand economy as a whole.
- 6.10 Based on the information available, Economic Insights found that over both the long term and the short term, there was no robustly identifiable productivity differential between the gas distribution and gas transmission industries and the economy as a whole. Similarly, based on the limited information available, there did not appear to have been an identifiable input price difference between these industries and the economy as a whole.
- 6.11 While not providing definitive guidance, the review of overseas GPB total factor productivity (TFP) included within the Economic Insights report was consistent with the conclusion that GPB productivity performance has not been demonstrably different from that of the New Zealand economy as a whole.
- 6.12 Ultimately, Economic Insights concluded that the longer run Multi-Factor Productivity (MFP) growth rate of 0.5% for the New Zealand economy as a whole was within the range of TFP growth rates observed for Australian GDBs and was similar to that reported for North American GDBs over a comparable period.
- 6.13 A shortage of complete, consistent and relevant data relating to the historical performance of GPBs limited the ability of Economics Insights to obtain more robust results and we accept that this presents complications in setting an X-factor other than zero.

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<sup>59</sup> Economic Insights Pty Limited, *Regulation of Suppliers of Gas Pipeline Services – Gas Sector Productivity*, 10 February 2011.

- 6.14 While recognising the shortage of complete, consistent and robust relevant data, Economic Insights' initial review of both direct and indirect approaches to assessing whether GPB TFP growth and GPB input price growth have been similar to those for the New Zealand economy as a whole, points to there being no strong evidence to the contrary.<sup>60</sup>
- 6.15 The evidence available therefore lends support to a value of zero being attributed to the X-factor for GPBs under an Initial DPP.

### **Future Availability of Gas Sector Data**

- 6.16 Another relevant feature of the regulatory context for setting rate(s) of change under a DPP is the availability of data.
- 6.17 At present, all GPBs are required to submit information under the Gas (Information Disclosure) Regulations 1997. As noted above, the work of Economic Insights indicated that additional data is desirable for the purposes of establishing X values at subsequent DPP resets.
- 6.18 From 2012, we will set information disclosure requirements under Part 4 for GPBs. We propose to release draft information disclosure determinations for EDBs and GPBs in December 2011.<sup>61</sup>

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<sup>60</sup> Economic Insights Pty Limited, Regulation of suppliers of Gas Pipeline Services – Gas Sector Productivity, 10 February 2011.

<sup>61</sup> For an updated timeframe on the proposed release of draft information disclosure determinations, please visit <http://www.comcom.govt.nz/gas-information-disclosure/>

## SECTION 7 PRICE AND REGULATORY PERIODS UNDER THE INITIAL DEFAULT PRICE-QUALITY PATHS

### Commission's Draft Decision

- 7.1 Our draft decision is that the regulatory period for the Initial DPP should start on 1 July 2012 and end on 30 September 2016. This means that the Initial DPP shall be for a regulatory period of four years and three months.
- 7.2 Our draft decision is that the prices at the start of the default price-quality paths, for both the suppliers of gas distribution and gas transmission services, must be the prices that applied on a defined date in the past. The dates in question are:
- 30 June 2010 for GTBs and those GDBs not subject to the Gas Authorisations
  - for those GDBs subject to the Gas Authorisations, the date the Order expires.
- 7.3 We intend to consult on whether starting prices as at 1 July 2012 should be reset in accordance with s 55F(4) of the Act once the additional input methodologies required by the High Court have been determined.

### Introduction

- 7.4 This section sets out how price is specified under the Initial DPP. The following issues relating to price under the Initial DPP are discussed in this section:
- starting prices under the Initial DPP
  - the regulatory period that will apply for the Initial DPP, and
  - the form of the price paths, including how price and other elements are defined and specified for suppliers of gas distribution and gas transmission services.

### Form of the Price Path under the Initial Default Price-Quality Path

- 7.5 In relation to price, the Initial DPP must specify the maximum price or maximum revenues of a GPB.<sup>62</sup> The Act requires the Initial DPP to also specify the starting prices and rate of change that apply to GPBs.<sup>63</sup>

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<sup>62</sup> Section 52C of Part 4 defines prices as: (a) means any 1 or more of individual prices, aggregate prices, or revenues (whether in the form of specific numbers, or in the form of formulas by which specific numbers are derived); and (b) includes any related terms of payment.

- 7.6 The IMs detail the specification and definition of prices that must apply to GPBs.<sup>64</sup> The IMs must be applied in determining the Initial DPP, hence a maximum price for GPBs has been specified in the form of a price path, which incorporates applicable starting prices and the rate of change.

### Starting Prices under the Initial Default Price-Quality Paths

- 7.7 Section 53P(3) states that starting prices must be either the prices that applied at the end of the preceding regulatory period (s 53P(3)(a)) or prices that are based on the current and future profitability of each supplier (s 53P(3)(b)).
- 7.8 In the August Discussion Paper, we considered prices that are based on the current and future profitability of each supplier were likely to better promote the Part 4 Purpose (as opposed to rolling-over existing prices under s 53P(3)(a)).<sup>65</sup>
- 7.9 Some submissions to the August Discussion Paper were in favour of our proposed approach, but others were of the opinion that various elements of the methodology we proposed to employ for setting prices under the Initial DPP required further consideration.<sup>66</sup>
- 7.10 However, on 26 September, the High Court ruled that input methodologies should be developed that specify how starting prices will be applied to EDBs and GPBs under s 53P(3)(b).<sup>67</sup>
- 7.11 The High Court judgment therefore prevents us from setting prices for GDBs and GTBs under s 53P(3)(b) for the Initial DPPs until the additional input methodologies have been developed. We propose to release for consultation a separate issues paper for the development of these input methodologies.

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<sup>63</sup> Section 53O specifies that a 52P determination must set out a default price-quality path that includes, among other things, the starting prices that apply to the supply of goods or services during the first regulatory period (s 53O(a)) and the rate or rates of change in prices, relative to the consumer price index, allowed during the first regulatory period (s 53O(b)).

<sup>64</sup> Commerce Commission, *Commerce Act (Gas Distribution Services Input Methodologies) Determination 2010*, 22 December 2010, Part 3, subpart 1 and Commerce Commission, *Commerce Act (Gas Transmission Services Input Methodologies) Determination 2010*, 22 December 2010; and Commerce Commission, *Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper*, 22 December 2010, Part 3, subpart 1.

<sup>65</sup> Commerce Commission, *Setting of Starting Prices for Gas Pipeline Businesses under the Initial Default Price-Quality Path Discussion Paper*, 22 August 2011, paragraph X.5.

<sup>66</sup> GasNet Limited, *Submission on Setting of Starting Prices for Gas Pipeline Businesses*, 28 September 2011, paragraph 23; Powerco Limited, *Setting of Starting Prices for Gas Pipeline Businesses under the Initial Default Price-Quality Path Discussion Paper*, 28 September 2011, paragraphs 3-18 and Vector Limited, *Submission on the Setting of Starting Prices for Gas Pipeline Businesses under the Initial Default Price-Quality Path*, 28 September 2011, paragraphs 6-31.

<sup>67</sup> *Vector Limited v Commerce Commission* HC Wellington CIV 2011-485-536, 26 September 2011.

- 7.12 The High Court has confirmed that we may proceed to set the Initial DPP with starting prices under s 53P(3)(a) before the additional IMs are determined, and we therefore propose to set prices for the Initial DPPs on this basis.
- 7.13 We remain of the view that prices based on current and future profitability of each supplier are likely to better promote the Part 4 Purpose. This is reflected in our discussion of s 55F(4) resets below.
- 7.14 We are nonetheless electing to proceed with the Initial DPPs with starting prices rolled-over from the previous regulatory period as this crystallises two aspects of the regime that are important to ensuring the Part 4 Purpose is met:
- the right of a regulated supplier to seek a CPP
  - our ability to apply claw-back if starting prices are reset under s 55F(4).

***Starting Prices for Suppliers not subject to the Gas Authorisations***

- 7.15 For MDL, GasNet and part of Vector's network, Initial DPPs with starting prices set under s 53P(3)(a) means that the prices that applied 'at the end of the preceding regulatory period' must be applied, and s 55F(1) specifies that this date must be 30 June 2010. The effect is that any CPI adjustments following 30 June 2010 would not be included in the starting prices for the Initial DPPs for those businesses not subject to the Gas Authorisations.
- 7.16 To include CPI adjustments would mean s 53P(11) as saying that if a decision is made on starting prices after the regulatory period should have begun, the roll-over price is the price that applied at the end of the previous period with any ongoing rate of change adjustment applied (i.e. the CPI adjustment referred to in s 55F(2) giving us the implicit rate of change). Although we have considered this, our draft decision is that CPI adjustments cannot be included.
- 7.17 We note that this is an unfortunate consequence, and that this would have been avoided if we had been able to set starting prices based on the current and future profitability of GPBs as previously proposed. If we do reset prices following the development of starting price input methodologies we will, subject to consultation, apply claw-back in the event that the use of June 2010 starting prices results in businesses under-recovering returns from 1 July 2012.
- 7.18 Given the normal timing of price changes, we do not expect GPBs to reduce their prices on 1 July (at the start of the Initial DPPs) to conform to prices that were applicable at 30 June 2010. We propose that GPBs would be allowed to delay required price changes until 1 October 2012, but the changes implemented would need to compensate users of gas pipeline services for any over-charging in the price path for the first three months of the Initial DPP.

***Starting Prices for Suppliers subject to the Gas Authorisations***

- 7.19 For those GDBs currently subject to the Gas Authorisations, under s 55H(2) the expiry of the Order must be treated as the end of a CPP and s 53X applies.

7.20 Section 53X(2) provides that the starting prices for these businesses are those that applied at the end of the CPP unless, at least four months before the end of CPP (i.e. the Order), we advise the supplier that different starting prices must apply. Consistent with our draft decision for those GDBs not subject to the Gas Authorisations, our draft decision is that the starting prices that will apply to those GDBs subject to the Gas Authorisations will be those that apply at the expiry of the Order.

### **Section 55F(4) Reset**

7.21 Once the additional input methodologies have been determined, there is a nine month window in which we may reset the default price-quality path under s 55F(4) if a materially different path would have been set had input methodologies applied at the time the default price-quality paths were determined. The earliest that price adjustments could take effect is 2013, although the actual date for adjustments is dependent on the date on which the additional input methodologies are determined.

7.22 If we do reset the Initial DPP then our current expectation is that, subject to consultation, we would be likely to exercise the discretion provided in s 55F(4) to apply claw-back from the start of the regulatory period.<sup>68</sup> Claw-back is a reference to:

- requiring a supplier to lower its prices on a temporary basis to compensate consumers for some or all of any over-recovery that occurred under the process previously charged by the supplier, or
- allowing the supplier to recover some or all of any shortfall in its revenues that occurred under the prices previously charged by the supplier.<sup>69</sup>

7.23 We consider that we may reset the Initial DPP if s 55F(4) is satisfied, even though we have set starting prices by 'rolling-over' prices from a previous regulatory period.

### **Application of Claw-Back under s 55F(2)**

7.24 Separately from claw-back under s 55F(4) discussed immediately above, s 55F(2) states:

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<sup>68</sup> Section 55F(4) states that: *"If an input methodology is published after a section 52P determination referred to in subsection 1 is made, and if, had that methodology applied at the time the default price-quality paths were set as required by subsection (1), it would have resulted in a materially different path being set, then the Commission may reset the default price-quality paths and may apply claw-back, despite section 53ZB(1)."*

<sup>69</sup> Section 52D(1) requires clawback to be spread over time if the Commission applies this approach.

However, 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.

- 7.25 We set out in the April Discussion Paper that we did not consider claw-back under s 55F(2) should be applied to GPBs for the Initial DPP.<sup>70</sup>
- 7.26 This was because we agreed with a proposed approach put forward by Vector to demonstrate that any price increases relating to their gas pipeline services not included under the Gas Authorisation would be made in line with CPI to meet the requirements of s 55F(2) of the Act. We consider that this should result in Vector not being subject to claw-back applied under s 55F(2) of the Act.
- 7.27 We also considered that suppliers of services controlled under the Gas Authorisations should not have to demonstrate that prices had increased in line with CPI, as this would duplicate their reporting requirements under the authorisations.
- 7.28 We also consider it is unlikely that we will need to apply claw-back to the gas transmission services provided by MDL, given that it already utilises a building blocks approach to the setting of prices for the pipeline services it provides. While a building blocks approach does not imply that CPI increases have been taken into account, our understanding remains that MDL's tariff model does include annual adjustments for CPI.
- 7.29 Furthermore, in their submission to the April Discussion Paper, GasNet confirmed they have not increased prices by more than inflation since the introduction of Part 4 in 2008, and that they agree with our previous position that claw-back will not be relevant under the Initial DPP to the gas distribution services they provide.
- 7.30 Submissions to the April Discussion Paper therefore supported our proposed approach and agreed that the application of claw-back under s 55F(2) should not be applied for the Initial DPP.<sup>71</sup>

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<sup>70</sup> Commerce Commission, *Initial Default Price-Quality Path for Gas Pipeline Businesses - April Discussion Paper*, 1 April 2011, paragraphs 5.21-5.27.

<sup>71</sup> GasNet Limited, *Submission on Initial Default Price-Quality Path for Gas Pipeline Businesses*, 27 May 2011, paragraph 18; Maui Development Limited, *MDL Commerce Commission Submission: Initial Default Price-Quality Path for Gas Pipeline Businesses Discussion Paper April 2011*, 27 May 2011, paragraph 4.2 and Vector Limited, *Submission on the Commerce Commission's Initial Default Price-Quality Path for Gas Pipeline Businesses: Discussion Paper*, 27 May 2011, paragraphs 98-100;

## Regulatory Period that will apply under the Initial Default Price-Quality Path

- 7.31 Every default price-quality path must specify, among other things:
- the date or dates on which the default price-quality path (or any part of it) takes effect<sup>72</sup>
  - the annual date by which compliance with the DPP must be demonstrated in accordance with s 53N<sup>73</sup>
  - the regulatory period.<sup>74</sup>
- 7.32 We previously set-out in the April Discussion Paper our proposal to set the Initial DPPs from 2 July 2012 for a period of four years and three months, and explained why that was preferable to a later or earlier start date.

### **Regulatory Period start date of 1 or 2 July 2012**

- 7.33 Given that the Order expires at the end of 1 July 2012, in the April Discussion Paper we considered whether we should determine the Initial DPP to commence on 2 July 2012 to allow for a tidy transition to the Initial DPP for Powerco and Vector, which are currently subject to the Order.<sup>75</sup> The Order under which the Gas Authorisations are controlled does not expire until the end of 1 July 2012.<sup>76</sup>
- 7.34 Most submissions to the April Discussion Paper did not raise objections with this approach, but GasNet did not support a regulatory period starting on 2 July. This was because they considered that the Gas Authorisations only apply to two GDBs and that this should not influence the start of the DPP for other suppliers of gas pipeline services.<sup>77</sup>
- 7.35 Our draft decision is that the regulatory period should start on 1 July 2012. This will provide continuity of regulation for Powerco and Vector even though overlapping for one day with the Gas Authorisations.
- 7.36 In assessing Powerco's and Vector's compliance with the Initial DPP, we propose a pragmatic approach to the one day of the regulatory period.

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<sup>72</sup> Section 53O(d) of the Act.

<sup>73</sup> Section 53O(f) of the Act.

<sup>74</sup> Section 53M(1)(c) of the Act.

<sup>75</sup> Commerce Commission, *Initial Default Price-Quality Path for Gas Pipeline Businesses Discussion Paper*, 1 April 2011, paragraphs 8.15-8.18.

<sup>76</sup> *Commerce (Control of Natural Gas Services) Order 2005*.

<sup>77</sup> GasNet Limited, *Submission on Initial Default Price-Quality Path for Gas Pipeline Businesses*, 27 May 2011, paragraph 40.b.

Excluding the 24 hours of 1 July 2012 from the first assessment period would increase costs by requiring the extraction of this day from the data that is routinely collected by GDBs on a monthly basis. We consider that the pragmatic approach is to include this day in the regulatory period given that prices at the start of the regulatory period will be the same as those at the end of the Gas Authorisations. This is discussed further in Section 8 of this paper.

- 7.37 A 1 July start date would also allow individual GPBs to apply for a CPP should the rolling-over of prices under s 53P(3)(a) not meet their particular circumstances. This option would be available once the Initial DPPs have been implemented, which is another reason why it is important to proceed with establishing Initial DPPs as soon as possible.
- 7.38 We must also determine how long the Initial DPPs should be set for (i.e. the length of the regulatory period). Under s 53M(4), a regulatory period must be five years. However, s 53M(5) provides for a shorter period (of no less than four years) if that would better meet the Part 4 Purpose.
- 7.39 Given s 55F(1), it may appear that the length of the regulatory period for the Initial DPPs should be calculated from 1 July 2012. As previously set-out in our April Discussion Paper, we do not believe that the Commission is able to set Initial DPPs from an earlier date, for example 1 July 2010. Section 53M(7) prevents us from setting a DPP that applies retrospectively. This approach is also consistent with Part 4 providing for *ex ante* regulation.
- 7.40 We previously set-out in the April Discussion Paper our proposal to set the regulatory period for the Initial DPPs for a period of four years and three months, and our draft decision is that this should apply for the Initial DPPs.<sup>78</sup> This means that the Initial DPPs regulatory period will terminate on 30 September 2016 and will allow the DPP reset to align with the pricing years of most GPBs (that start on 1 October each year).

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Commerce Commission, *Initial Default Price-Quality Path for Gas Pipeline Businesses Discussion Paper*, 1 April 2011, paragraph 8.24.

## SECTION 8 MONITORING OF COMPLIANCE

### Commission's Draft Decision

- 8.1 Our draft decision is that an *ex ante* form of compliance should apply to the prices of GPBs under the Initial DPP. We also consider that an *ex post* form of compliance should apply to the quality standards for GPBs under the Initial DPPs.
- 8.2 Our draft decision is that annual compliance statements should be made by 30 November each year, with the first one due on 30 November 2012, and with the last one for the Initial DPPs being due on 30 November 2016. Compliance with the price path would be demonstrated *ex ante* in each annual compliance statement except the last one, and would relate to the assessment period ending 10 months after the due date of the annual compliance statement. Compliance with quality standards would be demonstrated *ex post* in each annual compliance statement except the first one, and each one would relate to the assessment period ending two months prior to the due date for the annual compliance statement.
- 8.3 It is also our draft decision that the assessment periods of all GPBs should align to 1 October, with annual assessment periods of 1 October to 30 September for each year of the Initial DPPs. This will align with the current pricing years of GasNet, Powerco and Vector. The first assessment period will be an exception to these 1 October to 30 September periods, and will be for the 15 month period from 1 July 2012 to 30 September 2013.

### Our Approach to Compliance under the Initial Default Price-Quality Path

- 8.4 We have a role in monitoring the compliance of suppliers with a DPP as provided for under s 53N of the Act. Section 53N notes that:
- ...the Commission may, ... issue a written notice to a regulated supplier requiring it to provide any or all of the following:
- (a) a written statement that states whether or not the supplier has complied with the price-quality path applying to that supplier:
  - (b) a report on the written statement referred to in paragraph (a) that is signed by any auditor in accordance with any form specified by the Commission:
  - (c) sufficient information to enable the Commission to properly determine whether all applicable price-quality paths have been complied with:
  - (d) a certificate, in the form specified by the Commission and signed by at least one director of the supplier, confirming the truth and accuracy of any information provided under this section.

- 8.5 The method of compliance with the price paths has been developed consistent with the decision to roll-over prices according to s 53P(3)(a) and with the “specification of price” section of the IMs.<sup>79</sup>
- 8.6 The remainder of this section sets out the information that we propose to require each GPB to provide to us to demonstrate compliance with the price paths of the Initial DPPs. We have included relevant s 53N provisions in each of the Draft Determinations that have been released for consultation at the same time as this paper.

## Form of Compliance

- 8.7 In the April Discussion Paper, we proposed how compliance with the price paths for GPBs would be assessed, but we did not specify at that time other general compliance requirements for GPBs in relation to the Initial DPPs.<sup>80</sup>
- 8.8 Our draft decision is that an *ex ante* form of compliance should apply to GPBs for the Initial DPPs. Our reasoning for this approach is that GPBs will be able to confirm whether they will be compliant with the price paths before the end of each assessment period. This allows us to take a pro-active approach to ensuring compliance, and to take any enforcement action if appropriate.<sup>81</sup>
- 8.9 However, it should be recognised that the draft determinations require GPBs to supply audit confirmation *ex post* that their *ex ante* compliance statements are accurate.
- 8.10 It would clearly not be possible for GPBs to provide *ex ante* compliance statements in regards to quality standards under the Initial DPPs, as quality standards cannot be foreseen before the end of the assessment period. Therefore, for quality standards, our draft decision is that compliance should be demonstrated on an *ex post* basis after the end of each assessment period.
- 8.11 We have also included in the Draft Determinations specific provisions to cater for transactions that a GPB may enter into in regarding an acquisition, amalgamation, takeover or disposal with another business. It is important for us to ensure that any transactions do not result in an under or over-recovery of a GPB’s revenues in an assessment period, and these requirements are based on our previous approach for dealing with transactions for EDBs.

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<sup>79</sup> Commerce Commission, *Commerce Act (Gas Distribution Services Input Methodologies) Determination 2010*, 22 December 2010, Part 3, subpart 1 and Commerce Commission, *Commerce Act (Gas Transmission Services Input Methodologies) Determination 2010*, 22 December 2010; and Commerce Commission, *Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper*, 22 December 2010, Part 3, subpart 1.

<sup>80</sup> Commerce Commission, *Initial Default Price-Quality Path for Gas Pipeline Businesses - April Discussion Paper*, 1 April 2011, page. 23.

<sup>81</sup> We note that this approach differs from that applied to EDBs, but consider that the level of pass-through and recoverable costs are likely to be lower for GPBs than for EDBs. We therefore do not consider an *ex ante* form of compliance to be problematic for GPBs in this regard.

## Basis for the Generic Weighted Average Price Cap Formulas

- 8.12 The formulas for the WAPC are not necessarily intuitive. We explain them by first considering the simple case of a WAPC where perfect information is available, and where there is no pass-through or recoverable costs, but there is a CPI minus X price adjustment.
- 8.13 The cap would require the prices being set for a year to be such that notional revenue, obtained by applying those prices to the previous year's quantities, is no more than the previous year's revenue inflated by CPI minus X. This would be given by:

$$NR_t \leq R_t$$

where

$NR_t$  is the *notional revenue* for the assessment period  $t$ , being equal to:

$$\sum_i P_{i,t} Q_{i,t-1}$$

$R_t$  is the *allowable notional revenue* for the assessment period  $t$ , being equal to

$$\sum_i P_{i,t-1} Q_{i,t-1} \times (1 + \Delta CPI_t) \times (1 - X)$$

where

$t$  denotes the period to which a variable relates, and is the year in which the period ends

$i$  denotes each component of price relating to a gas pipeline service

$P_{i,t}$  is the  $i^{\text{th}}$  price during any part of the assessment period  $t$ <sup>82</sup>

$P_{i,t-1}$  is the  $i^{\text{th}}$  price during any part of the assessment period  $t-1$

$Q_{i,t-1}$  is the total quantity corresponding to the  $i^{\text{th}}$  price during the 12 month assessment period  $t-1$ <sup>83</sup>

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<sup>82</sup> All prices are expressed exclusive of GST.

<sup>83</sup> A quantity "corresponding" to a price means the quantity measure to which the price would be applied. For example, a price in the form of a fixed daily charge would have as its corresponding quantity the number of connections to which that charge applies. A variable

$X$  is the X factor, i.e. the rate of change for the GDB (zero)

$\Delta CPI_t$  is the derived change in the CPI to be applied during the Assessment Period  $t$ , being equal to:

$$\frac{CPI_{Jun,t-2} + CPI_{Sep,t-2} + CPI_{Dec,t-2} + CPI_{Mar,t-1}}{CPI_{Jun,t-3} + CPI_{Sep,t-3} + CPI_{Dec,t-3} + CPI_{Mar,t-2}} - 1$$

where:

$CPI_{q,t}$  is the CPI for the quarter  $q$  of year  $t$ , where CPI is as defined in the GPB IMs.<sup>84</sup>

8.14 This price cap would not however be feasible for setting prices. This is because the quantities for the previous year ( $Q_{i,t-1}$ ) would not be available at the time of setting prices, which will be towards the end of the previous year ( $t-1$ ). We did not consider the use of forecast quantities to deal with the lack of actual quantities being available, as clause 3.1.1(5) of the GDB IMs, and clause 3.1.1(7) of the GTB IMs require that forecast quantities must not be used.

8.15 Quantities lagged by two years ( $t-2$ ) have been used instead of the quantities of the previous year. Quantities for the  $t-2$  year will be available when setting prices, and have been used in determining both the notional revenue and the allowable notional revenue as follows:

$$\sum_i P_{i,t} Q_{i,t-2} \leq \sum_i P_{i,t-1} Q_{i,t-2} \times (1 + \Delta CPI_t) \times (1 - X)$$

8.16 Some costs are to be passed through, which requires the regulatory controls to operate on revenues net of pass-through and recoverable costs. The  $\Sigma PQ$  terms on both the left hand and right hand sides of the formula above need to have the pass through ( $K$ ) and recoverable ( $V$ ) amounts subtracted from them, such that the formula becomes:

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charge in the form of a \$ per Gigajoule charge for a particular load group would have as its corresponding quantity the total number of Gigajoules supplied to consumers in that load group.

<sup>84</sup> Note that the IMs require the CPI for quarters prior to December 2010 to be determined by multiplying the values published by Statistics New Zealand by 1.02. Note also that a lagged CPI formula has been used, with the most recent index in the formula being 6 months prior to the price change being applied, which should give sufficient time for the calculations to be performed.

$$\sum_i P_{i,t} Q_{i,t-2} - K_t - V_t \leq (\sum_i P_{i,t-1} Q_{i,t-2} - K_{t-1} - V_{t-1}) \times (1 + \Delta CPI_t) \times (1 - X)$$

where

$K_{t-1}$  is the sum of all pass-through costs during the assessment period  $t-1$

$V_{t-1}$  is the sum of all recoverable costs during the assessment period  $t-1$

- 8.17 A potential issue arises if a GPB sets its prices such that its notional revenue  $NR_t$  is materially less than its allowable notional revenue  $R_t$ . Not only will the GPB receive less revenue in the year of those prices, but because those prices will be used in the setting of the allowable notional revenue for the subsequent year, the effect could be to lock in that reduction in prices (relative to what could have been charged) for all subsequent years of the regulatory period.
- 8.18 We refer to the amount by which a GPB has under-priced its services (which is  $R_{t-1} - NR_{t-1}$ ) as 'head room'. A head room term can be included in the right hand side of the formula above to reverse the effect of head room created in the previous year, and this results in the following formula:

$$\sum_i P_{i,t} Q_{i,t-2} - K_t - V_t \leq (\sum_i P_{i,t-1} Q_{i,t-2} - K_{t-1} - V_{t-1} + (R_{t-1} - NR_{t-1})) \times (1 + \Delta CPI_t) \times (1 - X)$$

- 8.19 This formula expresses the weighted average price cap control as generally applied in the DPP. It will be used for all GDBs for all assessment periods except for the first assessment period, which requires a somewhat different formula to deal with the fact that the first assessment period is to be 15 months, and because in some cases starting prices are to be based on prices from 2010.

### Basis for the Generic Total Revenue Cap Formulas

- 8.20 For assessment periods other than the first assessment period, the formula for a TRC can be expressed very simply in terms of the allowable notional revenue of the previous year as a TRC should allow allowable revenue to grow by CPI-X each year.
- $$R_t = R_{t-1} \times (1 + \Delta CPI_t) \times (1 - X)$$
- 8.21 The issue then is to determine the allowable revenue for the first year in which a TRC is to be applied.
- 8.22 We explain the formula for the first year of a TRC by first considering the simple case of a TRC where perfect information is available, and where there are no pass through or recoverable costs, but there is a CPI-X price adjustment.

- 8.23 The cap would require the prices being set for the first year to be such that the revenue in the year for which prices are being set are no more than the previous year's revenue inflated by CPI-X. This would be given by:

$$NR_t \leq R_t$$

where

$NR_t$  is the *notional revenue* for the assessment period  $t$ , being equal to:

$$\sum_i P_{i,t} Q_{i,t}$$

$R_t$  is the *allowable notional revenue* for the assessment period  $t$ , being equal to

$$\sum_i P_{i,t-1} Q_{i,t-1} \times (1 + \Delta CPI_t) \times (1 - X)$$

- 8.24 Note that the lag for the  $Q$  variable in the formula for  $R_t$  (i.e.  $Q_{i,t-1}$ ) is lagged by one more year than the lag for the  $Q$  variable in the formula for  $NR_t$  (i.e.  $Q_{i,t}$ ). This is an essential feature of a normal revenue cap; the higher  $Q_{i,t}$  is relative to  $Q_{i,t-1}$ , the lower the prices to be set (i.e.  $P_{i,t}$ ) must be to compensate for the growth in demand. This is precisely the effect required for a TRC.
- 8.25 This revenue cap would not however be feasible for setting prices. The quantities for the year for which prices are to be set year ( $Q_{i,t}$ ) would not be available at the time of setting prices, which will be towards the end of the previous year ( $t-1$ ). As with the WAPC, we did not consider the use of forecast quantities to deal with the lack of actual quantities being available, as clause 3.1.1(7) of the gas transmission services IMs require that forecast quantities must not be used.
- 8.26 The lag in both of the quantities in the formulas at paragraph 8.23 have been increased by two years, thus preserving the one year difference between the quantities used for  $NR_t$  and the quantities used for  $R_t$ . The amount of lag is the minimum that can be used and still have the quantity data available when it is required for price setting.
- 8.27 The formulas for  $NR_t$  and  $R_t$  then become:

$NR_t$  is the *notional revenue* for the assessment period  $t$ , being equal to:

$$\sum_i P_{i,t} Q_{i,t-2}$$

$R_t$  is the *allowable notional revenue* for the assessment period  $t$ , being equal to:

$$\sum_i P_{i,t-1} Q_{i,t-3} \times (1 + \Delta CPI_t) \times (1 - X)$$

- 8.28 The formulas above in the previous paragraph do not account for pass-through or recoverable costs. These formulas can be adapted to deal with these issues in the same way as for the WAPC formulas, and the revenue cap formulas for the first year are then derived as follows:

$$NR_t \leq R_t$$

where

$NR_t$  is the *notional revenue* for the assessment period  $t$ , being equal to:

$$\sum_i P_{i,t} Q_{i,t-2} - K_t - V_t$$

$R_t$  is the *allowable notional revenue* for the assessment period  $t$ , being equal to:

$$\left( \sum_i P_{i,t-1} Q_{i,t-3} - K_{t-1} - V_{t-1} \right) \times (1 + \Delta CPI_t) \times (1 - X)$$

- 8.29 This formula has been used as a basis for setting the allowable notional revenue for the first assessment period (no head room term ( $R_{t-1} - NR_{t-1}$ ) is required as head room is not created prior to the commencement of the Initial DPPs). For assessment periods other than the first assessment period, the recursive formula set-out in paragraph 8.20 has been used, which directly expresses that the allowable notional revenue should grow by CPI-X each year.
- 8.30 Note that the recursive formula does not contain pass-through or recoverable cost terms. The first application of this formula will be for setting the prices for the year ending 30 September 2014 (i.e.  $t=2014$ ). The right-hand side will include  $R_{2013}$  which will have had pass-through and recoverable costs subtracted when being calculated (i.e.  $R_{2013}$  will be net of the notional revenue required to fund these costs). Because the first  $R$  value ( $R_{2013}$ ) will be a net value, and all subsequent  $R$  values will be the result of a simple CPI-X indexation of that first value, all those subsequent values will be net of pass-through and recoverable costs. No further adjustment for pass-through or recoverable costs will be required when calculating the allowable notional revenue. The notional revenue formula contains terms for pass-through and recoverable costs, so that prices will be set in a way in which pass-through and recoverable costs in the amounts of  $K_t$  and  $V_t$  can be notionally funded.
- 8.31 Note also that the formula at paragraph 8.20 does not create the head room issue that the WAPC formula at paragraph 8.18 creates. The WAPC formula uses the actual prices charged in a year to determine the allowable notional revenue for the following year, and it is this that causes a potential reduction in

allowable notional revenues for the rest of the regulatory period. By contrast, the formula in paragraph 8.20 above does not use actual prices charged, and if a GPB allows some head room in its price setting, that will have no impact on the following assessment period's allowable notional revenue. There is therefore no need to include a head room provision, as the head room will not have any effect in subsequent years.

### **Alignment of Pricing Year and Assessment Periods for the Initial Default Price-Quality Path**

- 8.32 Where pricing and assessment periods do not align, the assessment of compliance could be unnecessarily complex as it requires two sets of prices to be submitted across the assessment period. We note that submitters have previously voiced reservations over the potential to incur additional costs where 'partial-year compliance' is used.<sup>85</sup>
- 8.33 Our draft decision is that the pricing years should generally align with assessments periods except for a transitional assessment period of 15 months from 1 July 2012 to 30 September 2013 at the start of the Initial DPPs. For this one period, split period pricing will apply. This approach is considered more practicable and having lower compliance costs than having two assessment periods covering these 15 months, with separate compliance requirements, auditing and compliance reporting for each one.
- 8.34 MDL has a pricing year beginning 1 July while the remainder of GPBs have pricing years starting 1 October. This inconsistency in pricing years between GPBs means at least one GPB would be required adjust its pricing year date to achieve consistency across the GPBs.
- 8.35 We consider it preferable to align the pricing years and assessment periods of all GPBs. There are two reasons for this view.
- 8.36 Firstly, as all suppliers are subject to the same length of regulatory period, the mismatch between the different assessment periods of suppliers would continually require 'partial year' compliance for one or more GPBs in future regulatory periods.
- 8.37 Secondly, the alignment of pricing years and assessment periods for GPBs would make it easier for us to manage information flows and provides for consistency between businesses at future DPP resets (i.e. the provision of information across the same time periods would enable us to perform this task just once per year for all GPBs. It would also allow us to evaluate how the gas sector as a whole is performing and whether the compliance requirements we have set are appropriate).<sup>86</sup>

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<sup>85</sup> For example, Vector Limited, *Submission on Initial Default Price-Quality Path for Gas Pipeline Businesses: Issues Paper*, 14 May 2010, pp. 13-15.

<sup>86</sup> It is not our intention that the alignment of pricing years and assessment periods should be used to benchmark GPBs against one another. Section 53P(10) states we may not use

- 8.38 Assuming a regulatory period starting 1 July, assessment periods could either start on 1 July or 1 October with differing implications for suppliers.
- 8.39 Assessment periods starting 1 July would allow for a full five year regulatory period (i.e. 1 July 2012 – 30 June 2017) without any partial year compliance, as the end of the regulatory period would align with the start of the next pricing year and assessment period for the subsequent regulatory period.
- 8.40 Under a 1 October assessment period, and to align the pricing years of most GPBs (with the exception of MDL), an initial 15 month assessment period could be required for the period 1 July 2012 to 30 September 2013. The regulatory period would be four years and three months (i.e. 1 July 2012 – 30 September 2016) to align with the start of the first pricing year and assessment period for the subsequent regulatory period.<sup>87</sup>
- 8.41 The first assessment period will be for 15 months, from 1 July 2012 until 30 September 2013. It is expected that all GPBs will maintain prices constant at 30 June 2012 values for the first three months of the 15 month period, and adjust their prices from 1 October 2012. While GPBs will maintain prices constant for the first three months, this will not be a DPP requirement. The compliance requirement will be the allowable notional revenue constraints of the weighted average price caps and revenue caps, which will apply to the whole 15 month first assessment period as discussed below.

### **Applying the General Formulas to Specific Gas Pipeline Business Price Paths**

- 8.42 For all pipeline services, the generic formulas at paragraphs 8.18 (WAPC) and 8.27 (TRC) are applied for all assessment periods except the first assessment period. The first assessment period is for the 15 months from 1 July 2012 to 30 September 2013, rather than being for a standard 12 month period and therefore requires modified formulas to reflect this.
- 8.43 The CPI adjustment that is applied at the start of the first assessment period is for the 15 months of that period, rather than for a year. The formula for  $^{15}\Delta CPI_t$  that is used for the first assessment period reflects this.

### ***Effect of rolling over prices from 30 June 2010***

- 8.44 Section 55F(1) requires the Commission to make its first DPP determinations as if 30 June 2010 were the end of the previous regulatory period. It follows that a roll-over of prices per s 53P(3)(a) must roll over prices from 30 June 2010 for

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comparative benchmarking on efficiency in order to set starting prices, rates of change, quality standards or incentives to improve quality of supply.

<sup>87</sup> We understand that MDL could move to a 1 October pricing year without significant inconvenience to their business operations.

all GPBs other than those subject to the Gas Authorisations.<sup>88</sup> GPBs that have generally increased their prices by a CPI measure from 1 July 2010 and again from 1 July 2011 would have these CPI adjustments effectively reversed by the rolling-over of prices per s 53P(3)(a) as starting prices will be taken back to 30 June 2010 values. We note this effect, but consider we have no discretion to do otherwise when applying s 53P(3)(a) in conjunction with s 55F(1).

- 8.45 The rolling-over of prices for MDL using 30 June 2010 prices as starting prices will reverse a significant reduction in MDL's Tariff 2, which reduced from the 30 June 2010 rate of 9.4 cents per GJ to 3.9 cents per GJ from 1 July 2010. The rate currently remains at 3.9 cents per GJ. While the effect of applying the 30 June 2010 Tariff 2 as a starting price might appear to allow MDL a significant increase in revenue, we note that MDL continues to be constrained by the MPOC, and in particular by Schedule 10 of the MPOC.

### ***Non-standard Services***

- 8.46 Non-standard services are those that a GPB negotiates with an individual end-consumer, and for which the prices charged are not the GPB's prices for a standard service. For the purposes of applying the formulas for allowable notional revenue and notional revenue, each non-standard service is treated as a separate service, i.e. each one will have its own "i" suffix value in the formulas.
- 8.47 When applying a weighted average price cap for GDBs, a recently created non-standard service may be such that the lagged quantities for that service required by the formulas may not be available, or at least not available for a full year, when attempting to incorporate the non-standard service into the calculation of allowable notional revenue and notional revenue. In such a case, the lagged quantities shall be taken to be nil. The result will be consistent with the objective that under a WAPC, the GDB will take quantity risk.
- 8.48 When applying a revenue cap for GTBs, a recently created non-standard service may be such that the lagged quantities for the service required by the allowable notional revenue formula may not be available, while the lagged quantities required by the notional revenue formula may be available. In such a case, the lagged quantities shall be taken to be nil in the formula for the allowable notional revenue. The result will be consistent with the objective that under a revenue cap, the GTB will not take quantity risk.

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<sup>88</sup> Under s 53X(2), these GPBs' starting prices will be those that applied at the end of the Gas Authorisations.

### ***Pass through and recoverable costs***<sup>89</sup>

- 8.49 Pass-through and recoverable costs will, for some costs, be known for an assessment period prior to the commencement of that period. However, other costs will not be quantified early enough for them to be taken into account in setting prices for that period.
- 8.50 In their submission to the April Discussion Paper, Powerco expressed concern that a year of pass-through costs may be missed at the start of the Initial DPP as a result of the Gas Authorisations having a greater lag. We have sought to address these concerns in proposing our draft decision for the treatment of pass-through costs under the Initial DPP.<sup>90</sup>
- 8.51 We have considered the use of forecasts of pass-through costs and recoverable costs, but consider that some of the costs cannot be forecast with reasonable accuracy, and that it is preferable to use a system of lagged costs.
- 8.52 The variables  $K_t$  and  $V_t$  refer to the pass-through and recoverable cost amounts that have been used in determining the notional revenue for the period ending 30 September of year  $t$ . The variables do not necessarily refer to the costs that are incurred in year  $t$ , but rather to the costs, which may be lagged, that have been used in determining the  $K_t$  and  $V_t$  variables used in the formulas for notional revenue and allowable notional revenue. The value of these variables will be the costs to be incurred in year  $t$  that are known (with an audit trail) at the time prices are being set for that period, plus the pass-through and recoverable costs incurred in previous assessment periods that have not been able to be taken into account previously because the information was not available during a previous price setting round.
- 8.53 For example, gas balancing costs incurred during an assessment period ending on a particular 30 September will not be known until after that 30 September, as balancing costs can arise with short notice. When a GTB is setting prices for the forthcoming assessment period, gas balancing costs for the current assessment period will not be known, but the costs for the assessment period prior to the current one will be known. When setting prices for a particular assessment period, the balancing costs will therefore only be known with a two year lag. When determining its notional revenue for year  $t$ , a GTB will therefore typically include in its  $V_t$  value its balancing gas costs incurred in year  $t-2$ .
- 8.54 For some other pass-through and recoverable costs, the costs will be known earlier than for the example of gas balancing costs, and a one year rather than a

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<sup>89</sup> We note that the IMs do not allow GTBs to include costs associated with membership of the Electricity and Gas Complaints Commissioner Scheme to be treated as pass-through costs. However, we intend to amend the IMs to allow GTBs to include these as pass-through costs prior to the Initial DPP taking effect.

<sup>90</sup> Powerco, *Initial Default Price-Quality Path for Gas Pipeline Businesses Discussion Paper*, 27 May 2011, paragraphs 6-10.

two year lag will apply. This may apply for example to rates on fixed system assets payable to a local authority under the Local Government (Rating) Act 2002.

- 8.55 The process for calculating the values of  $K_t$  and  $V_t$  should reflect the following principles:
- the effect of taking pass-through and recoverable costs into account should be to reflect only changes in the value of these costs. If there is no change in value of a particular type of cost (eg balancing gas costs) then there should be no impact of that cost type on the allowable prices
  - a result of the above principle is that the scope of the pass through costs must be the same from one assessment period to the next
  - lagged values of pass through and recoverable costs shall be used when determining the values of  $K_t$  and  $V_t$ , with the extent of the lag for each type of cost being the amount necessary but not more than necessary to obtain the values for each type of cost.
- 8.56 The calculation of the notional revenue for the first assessment period must take into account all pass through and recoverable costs that are known by 1 July 2012. This date should give GPBs sufficient time to include these costs in the setting of prices that will take effect from 1 October 2012.
- 8.57 The calculation of the allowable notional revenue for each subsequent assessment period must use the  $K_t$  and  $V_t$  values from the calculation of the notional revenue for the previous year.
- 8.58 The use of lagged quantities for pass-through costs would lead, absent the concept set out in this paragraph, to some allowable notional revenues being affected by changes in pass-through costs that occurred entirely before the initial regulatory period. For example, a recoverable cost with a two year lag would require, for the setting of prices for the period ending 2013, to take into account costs incurred in the period ending 2011 when determining the notional revenue. When determining the allowable notional revenue in the same price setting exercise, the costs incurred in the period ending 2010 would need to be used. The result of this would be that cost changes between 2010 and 2011 would be passed through. We do not consider this appropriate.
- 8.59 To ensure that this effect does not occur, the latest costs that will be considered will be those incurred in periods ending 30 September 2012. Where the application of the formulas would require the use of costs incurred in periods ending prior to 30 September 2012, the costs incurred in the period to 30 September 2012 shall instead be used. This does not apply to the GDBs subject to the Gas Authorisations.
- 8.60 For the GDBs subject to the Gas Authorisations, a pass-through cost mechanism is currently in place. The timing of when pass-through costs have been made under the authorisations may not necessarily correspond with the timing under

the DPP, and there may also be differences between the two regimes as a result of the authorisation process being based on the difference between forecast and actual pass through costs, whereas the DPP process does not depend on forecasts. A specific allowance may be required to account for these differences, the allowance being an amount by which the 2013 notional revenue ( $NR_{2013}$ ) may exceed the 2013 allowable notional revenue ( $R_{2013}$ ).

8.61 The process set out in the DPP determinations for calculating the values of  $K_t$  and  $V_t$  is as follows:

- calculate, during the price setting process between 1 July 2012 and 1 August 2013,  $K_{2013}$  and  $V_{2013}$  such that all types of pass through costs and recoverable costs are taken into account, using lagged quantities to the extent necessary but not using lags any longer than necessary
- for all GPBs, calculate  $K_{2012}$  and  $V_{2012}$  such that all types of pass through costs and recoverable costs are taken into account, using the same amount of lag for each type of cost as was used in the calculation above of  $K_{2013}$  and  $V_{2013}$
- for all GPBs calculate  $K_{2014}$  and  $V_{2014}$  during the price setting process between 1 July 2013 and 1 August 2013, such that all types of pass-through costs and recoverable costs are taken into account, using the same amount of lag for each type of cost as was used in the calculation above of  $K_{2013}$  and  $V_{2013}$
- for all GPBs calculate  $K_t$  and  $V_t$  for all subsequent years during the price setting process each year between 1 July and 1 August of year  $t$ , in the same way as for  $K_{2014}$  and  $V_{2014}$
- for all GPBs, when calculating an allowable notional revenue  $R_t$ , use the values of  $K_{t-1}$  and  $V_{t-1}$  that were determined in the previous year when calculating the notional revenue.
- For GDBs subject to the Gas Authorisations, an amount may be allowed by which the 2013 notional revenue ( $NR_{2013}$ ) may exceed the 2013 allowable notional revenue ( $R_{2013}$ ) to account for differences between the pass through cost provisions of the gas authorisations and the pass through and recoverable cost provisions of the DPP.

### ***Gas Distribution Businesses currently subject to the Gas Authorisations***

8.62 The Order<sup>91</sup> under which the Gas Authorisations are controlled does not expire until the end of 1 July 2012. If compliance with the first assessment period were to exclude the 24 hours of 1 July 2012, compliance costs would include

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<sup>91</sup> Commerce (Control of Natural Gas Services) Order 2005

the possibly significant costs of the administrative tasks of excluding this day from data that is routinely collected by GDBs on a monthly basis. We consider that a pragmatic approach to this issue is to include this day within the compliance assessment period.

- 8.63 The formula for allowable notional revenue in paragraph 8.18 will apply for GDBs for setting prices for each year of the Initial DPP except for the first assessment period.
- 8.64 The allowable notional revenue for the first assessment period ( $^{15}R_{2013}$ ) is set out in paragraph 8.70 below. This incorporates the changes required to the formula in paragraph 8.18 to accommodate the first assessment period being for 15 months. A number of variables relate to 15 months rather than 12, and a pre-superscript has been used to indicate the number of months a variable represents. No pre-superscript means that a 12 month period ending on a 30 September is being referred to, by default. For example:
- $^{15}R_{2013}$  refers to the 15 month allowable notional revenue for the 15 months 1 July 2012 to 30 September 2013
  - $R_{2013}$  refers to the 12 month allowable notional revenue for the 12 months 1 October 2012 to 30 September 2013
  - $^3Q_{i,2009}$  refers to the three month period 1 July 2009 to 30 September 2009.
- 8.65 This convention for superscripts has been used throughout this section. The convention that periods finish on 30 September has also been used throughout this section, except where specifically indicated otherwise.
- 8.66 The formula for the 15 month CPI change ( $^{15}\Delta CPI_{2013}$ ) reflects that the CPI indexation is to apply to a 15 month period rather than a 12 month period. Each of the CPI indices in the numerator is 15 months later than the CPI index in the denominator immediately below it to reflect the 15 months of indexation.
- 8.67 The allowable notional formula in paragraph 8.18 includes the factor  $(1-X)$  to give effect to the rate of change ( $X$ ) being applied for one year. To take account of the assessment period being for 15 months rather than 12, this has been raised to the power of 1.25 in the formula for  $^{15}R_{2013}$  in paragraph 8.70 below.
- 8.68 The allowable notional revenue  $^{15}NR_{2013}$  in paragraph 8.70 is based on the prices applying at the end of the Gas Authorisations multiplied by the quantities over 15 months from 1 July 2010 to 30 September 2011.
- 8.69 The prices to be rolled-over are those applying at the end of the Gas Authorisations, which suggests that services not supplied on the last day of the Authorisations should not contribute to the allowable notional revenue for the first assessment period. Services excluded would include non-standard services provided at some time during the 15 months ending at the same time as the Gas Authorisations, but having ceased before this time.

- 8.70 The notional revenue ( $^{15}NR_t$ ) during the first 15 month assessment period of a GDB subject to a Gas Authorisation must not exceed the allowable notional revenue ( $^{15}R_t$ ) for the Assessment Period, such that:

$$^{15}NR_t \leq ^{15}R_t$$

where

$^{15}NR_{2013}$  is the *notional revenue* for the 15 month Assessment Period  $t$ , being equal to:

$$\sum_i {}^3P_{i,2012} {}^3Q_{i,2010} + \sum_i P_{i,2013} Q_{i,2011} - {}^{15}K_{2013} - {}^{15}V_{2013}$$

$^{15}R_{2013}$  is the annual *allowable notional revenue* for the 15 month First Assessment Period, being equal to:

$$\left( \sum_i P_{i,2012} {}^{15}Q_{i,2011} - {}^{15}K_{2012} - {}^{15}V_{2012} \right) \times (1 + {}^{15}\Delta CPI_{2013}) \times (1 - X)^{1.25}$$

where

${}^3P_{i,2012}$  is the  $i^{\text{th}}$  price applying between 1 July 2012 and 30 September 2012

$P_{i,2013}$  is the  $i^{\text{th}}$  price applying between 1 October 2012 and 30 September 2013

${}^3Q_{i,2010}$  is the quantity corresponding to the  $i^{\text{th}}$  price during the three month period from 1 July 2010 to 30 September 2010

$Q_{i,2011}$  is the quantity corresponding to the  $i^{\text{th}}$  price during the 12 month period from 1 October 2010 to 30 September 2011

$P_{i,2012}$  is the  $i^{\text{th}}$  price applying at 1 July 2012

${}^{15}Q_{i,2011}$  is the quantity corresponding to the  $i^{\text{th}}$  price during the 15 month period from 1 July 2010 to 30 September 2011. Note that the 15 month period of this quantity corresponds to the total of the three plus 12 month periods of  ${}^3Q_{i,2010}$  and  $Q_{i,2011}$  which are used in the calculation of  $^{15}NR_{2013}$  above.

${}^{15}K_{2013}$  is the sum of all pass-through costs during the 15 month period from 1 July 2012 to 30 September 2013

${}^{15}V_{2013}$  is the sum of all recoverable costs during the 15 month period from 1 July 2012 to 30 September 2013

${}^{15}K_{2012}$  is the sum of all pass-through costs during the 15 month period from 1 July 2011 to 30 September 2012

- $^{15}V_{2012}$  is the sum of all recoverable costs during the 15 month period from 1 July 2011 to 30 September 2012
- $X$  is the rate of change for the GDB (zero)
- $^{15}\Delta CPI_{2013}$  is the derived change in the CPI to be applied during the 15 month assessment period ending 30 September 2013, being:

$$\frac{CPI_{Mar,2011} + CPI_{Jun,2011} + CPI_{Sep,2011} + CPI_{Dec,2011} + CPI_{Mar,2012}}{CPI_{Dec,2009} + CPI_{Mar,2010} + CPI_{Jun,2010} + CPI_{Sep,2010} + CPI_{Dec,2010}} - 1$$

### **Value of the 2013 head room**

- 8.71 The formula for  $^{15}R_{2013}$  provides the 15 month allowable notional revenue, which will be used for checking compliance for the 15 months ending 30 September 2013. However, it does not readily provide the value  $R_{2013}$  which is for the 12 months ending 30 September 2012. In the same way, a formula for  $^{15}NR_{2013}$  is provided above, but no formula is available for the 12 month period ending 30 September 2013. These 12 month values are required for the ( $R_{2013} - NR_{2013}$ ) term in the equation for  $NR_{2014}$ :

$$NR_{2014} = \left( \sum_i P_{i,2013} Q_{i,2012} - K_{2013} - V_{2013} + (R_{2013} - NR_{2013}) \right) \times (1 + \Delta CPI_{2014}) \times (1 - X)$$

- 8.72 The 15 month head room value of  $^{15}R_{2013} - ^{15}NR_{2013}$  has been reduced to a 12 month value by a pro-rata calculation, i.e. by taking 80% (i.e.  $12 \div 15$ ) of the 15 month value. It could be arguable that this simple pro-rata approach does not take into account possible seasonality effects, but any seasonality effects are not expected to be material. Material values of head room should not occur as the DPP price controls have been designed to avoid any forecasting or approximating being required by GPBs when setting prices. The pro-rata approach has been adopted. GPBs should therefore be able to price with certainty, and not have to leave a material margin to ensure they do not breach the price path.

### **GDBs not subject to the Gas Authorisations**

- 8.73 The pricing for GDBs that are not subject to the Gas Authorisations shall be the same as the pricing for GDBs that are subject to the Gas Authorisations, except that the formulas need to reflect that starting prices are to be those applying at 30 June 2010, rather than at the end of the Gas Authorisations.

8.74 The allowable revenue  $^{15}R_{2013}$  and the definitions of  $P_{2010}$ ,  $^{15}Q_{i,2011}$ ,  $^{15}K_{2012}$  and  $^{15}V_{2012}$  shall be as set out below:

$^{15}R_{2013}$  is the *allowable notional revenue* for the 15 month first assessment period, being equal to:

$$\left( \sum_i P_{i,2010} {}^{15}Q_{i,2011} - {}^{15}K_{2012} - {}^{15}V_{2012} \right) \times (1 + {}^{15}\Delta CPI_{2013}) \times (1 - X)$$

where:

$P_{i,2010}$  is the  $i^{\text{th}}$  price applying at 30 June 2010

$^{15}Q_{i,2011}$  is the quantity corresponding to the  $i^{\text{th}}$  price during the 15 month period from 1 July 2010 to 30 September 2011

$^{15}K_{2012}$  is the pass-through cost for the 15 month period 1 July 2011 to 30 September 2012

$^{15}V_{2012}$  is the recoverable cost for the 15 month period 1 July 2011 to 30 September 2012

$^{15}\Delta CPI_{2013}$  is the derived change in the CPI to be applied during the 15 month assessment period ending 30 September 2013, being:

$$\frac{CPI_{Mar,2011} + CPI_{Jun,2011} + CPI_{Sep,2011} + CPI_{Dec,2011} + CPI_{Mar,2012}}{CPI_{Dec,2009} + CPI_{Mar,2010} + CPI_{Jun,2010} + CPI_{Sep,2010} + CPI_{Dec,2010}} - 1$$

8.75 The issue of a 12 month 2013 allowable notional revenue not being available arises in the same way as it does for GDBs subject to the authorisations and has been addressed in the same way. The discussion starting at paragraph 8.71 therefore also applies to GDBs not subject to the Gas Authorisations.

### **Gas Transmission Businesses**

8.76 The roll-over of prices for GTBs will be similar to that for GDBs not subject to the Gas Authorisations, except that GTBs will be subject to a TRC rather than a WAPC.

8.77 The formulas for pricing under a revenue cap shall be as set out below, and have been derived from the formulas set out at paragraphs 8.28 and 8.20:

$^{15}NR_{2013}$  is the *notional revenue* for the 15 month assessment period  $t$ , being equal to:

$$\sum_i {}^3P_{i,2012} {}^3Q_{i,2010} + \sum_i P_{i,2013} Q_{i,2011} - {}^{15}K_{2013} - {}^{15}V_{2013}$$

where

${}^3P_{i,2012}$  is the  $i^{\text{th}}$  price applying between 1 July 2012 and 30 September 2012

${}^3Q_{i,2010}$  is the quantity corresponding to the  $i^{\text{th}}$  price during the three month period from 1 July 2010 to 30 September 2010

$R_t$  is the *allowable notional revenue* for the 12 month assessment period  $t$ , other than the first assessment period, being equal to:

$$R_{t-1} \times (1 + \Delta CPI_t) \times (1 - X)$$

${}^{15}R_{2013}$  is the *allowable notional revenue* for the 15 month first assessment period, being equal to:

$$\left( \sum_i P_{i,2009} {}^3Q_{i,2009} + \sum_i P_{i,2010} Q_{i,2010} - {}^{15}K_{2012} - {}^{15}V_{2012} \right) \times (1 + {}^{15}\Delta CPI_{2013}) \times (1 - X)^{1.25}$$

where:

${}^{15}K_{2013}$  is the sum of all pass-through costs during the 15 month period 1 July 2012 to 30 September 2013

${}^{15}V_{2013}$  is the sum of all recoverable costs during the 15 month period 1 July 2012 to 30 September 2013

$P_{i,2009}$  is the  $i^{\text{th}}$  price applying during the period 1 July 2009 to 30 September 2009

${}^3Q_{i,2009}$  is the quantity corresponding to the  $i^{\text{th}}$  price during the three month period from 1 July 2009 to 30 September 2009

$P_{i,2010}$  is the  $i^{\text{th}}$  price applying at 30 June 2010

$Q_{i,2010}$  is the quantity corresponding to the  $i^{\text{th}}$  price during the 12 month period from 1 October 2009 to 30 September 2010

${}^{15}K_{2012}$  is the sum of all pass-through costs during the 15 month period 1 July 2011 to 30 September 2012

${}^{15}V_{2012}$  is the sum of all recoverable costs during the 15 month period 1 July 2011 to 30 September 2012

$X$  is the rate of change for the GTB (zero)

${}^{15}\Delta CPI_{2013}$  is the derived change in the CPI to be applied during the 15 month

assessment period ending 30 September 2013, being

$$\frac{CPI_{Mar,2011} + CPI_{Jun,2011} + CPI_{Sep,2011} + CPI_{Dec,2011} + CPI_{Mar,2012}}{CPI_{Dec,2009} + CPI_{Mar,2010} + CPI_{Jun,2010} + CPI_{Sep,2010} + CPI_{Dec,2010}} - 1$$

- 8.78 The issue of a 12 month 2013 allowable notional revenue not being available arises in the same way as it does for GDBs and has been addressed in the same way. The discussion starting at paragraph 8.71 therefore also applies to GTBs.
- 8.79 A 12 month 2013 allowable notional revenue ( $R_{2013}$ ) is also required, as it is referenced in the formula for the allowable notional revenue for 2014:

$$R_{2014} = R_{2013} \times (1 + \Delta CPI_{2014}) \times (1 - X)$$

- 8.80 The value of this 12 month value  $R_{2013}$  could be based on <sup>15</sup> $R_{2013}$  using the same pro-rata approach as is specified for the determination of the 12 month head room value, but seasonality effects could materially distort the result.
- 8.81 The 12 month  $R_{2013}$  value has instead been derived from the notional revenue in the 12 months ending 30 June 2010 using the generic formula for the allowable notional revenue for a TRC. Note that while this  $R_{2013}$  value is to be calculated using the formula for an allowable notional revenue, and the variable name used also suggests it is an allowable notional revenue, this value is not used as an allowable notional revenue for the year ending in 2013. It is used solely in the formula at paragraph 8.79 above. The formula for  $R_{2013}$  for the 12 month period 1 July 2009 to 30 June 2010 is as follows:

$$\sum_i P_{i,2010} Q_{i,2010} - K_{2012} - V_{2012}) \times (1 + \Delta CPI_{2013}) \times (1 - X)$$

where variables have the meaning below, noting that the convention used in the rest of this paper that periods for  $P$  and  $Q$  ending on a 30 September do not apply and:

$P_{i,2010}$  is the  $i^{\text{th}}$  price applying at 30 June 2010

$Q_{i,2010}$  is the quantity corresponding to the  $i^{\text{th}}$  price during the 12 month period from 1 July 2009 to 30 June 2010

$K_{2012}$  is the sum of all pass-through costs during the 12 month period 1 July 2011 to 30 June 2012

$V_{2012}$  is the sum of all recoverable costs during the 12 month period 1 July 2011 to 30 June 2012

$X$  is the rate of change for the GTB (zero)

$\Delta CPI_{2014}$  is the derived change in the CPI to be applied during the 12 month assessment period ending 30 September 2013, using the standard formula for a 12 month  $\Delta CPI_t$ .

### **Compliance with the Price and Quality under the Initial Default Price-Quality Paths**

- 8.82 Our draft decision is that each GPB should be required to provide an annual compliance statement, with necessary supporting information, that indicates whether it is complying with the price and quality paths for each assessment period of the Initial DPPs.
- 8.83 This approach is consistent with both the EDB DPP and the Gas Authorisations.
- 8.84 The specific requirements of the annual compliance statements are detailed in the Draft Determinations that have been released for consultation at the same time as this paper.
- 8.85 Sub-clause 3.1.3(2) of the IMs requires that any balancing gas cost or credit be approved by us. This approval will be required prior to the balancing gas cost or credit being treated as recoverable in the price setting process each year. The gas transmission services Draft Determination requires the GTB to submit a balancing gas statement to us by 31 March each year for approval by us by 31 May that year, with the balancing gas cost or credit being taken into account in setting the prices that will apply from 1 October of the same year. The process is set out in the gas transmission services Draft Determination.

**APPENDIX A: SUMMARY OF DRAFT DECISIONS ON THE INITIAL DEFAULT PRICE-QUALITY PATHS FOR GAS PIPELINE BUSINESSES**

Topic	View in Issues Paper	View in April Discussion Paper	Draft decision
<i>Section 3: Structure of the default price-quality path</i>			
Nature and scope of determination.	Gas distribution and transmission should be considered as different types of services for the purpose of the Initial DPP.	No change.  Approach is consistent with the specification of price in the IM determination.	Gas distribution and transmission pipeline services are considered to be different types of gas pipeline services for the purpose of the Initial DPP.
Differentiation of distribution and transmission services.	The distinction between distribution and transmission services may be made with reference to the definition of “transmission system” as set out in the Gas Governance (Critical Contingency Management) Regulations 2008.	Gas distribution and transmission services are suitably defined in the IMs that apply to them, and further definition is not required.	Gas distribution and transmission services are suitably defined in the IMs that apply to them, and further definition is not required.
Integrated versus separate price and quality standards (i.e. whether to have rewards or penalties associated with quality standards).	The Initial DPP should consist of separately specified and assessed price path and quality standards, rather than have price and quality dimensions integrated in some manner.	No change.	The Initial DPP should consist of separately specified and assessed price paths and quality standards, rather than have price and quality dimensions integrated in some manner.

Topic	View in Issues Paper	View in April Discussion Paper	Draft decision
<i>Section 4: Quality standards</i>			
Quality standards.	To the extent practicable, the regime will put in place objective quality standards with defined and measurable indicators.	One quality standard should apply to GPBs for the Initial DPP and this should be related to safety.  A number of additional quality measures should also be required to be disclosed as part of an information disclosure regime to help in the setting of further quality standards at future DPP resets.	One quality standard will apply to GPBs for the Initial DPP. This will be response times to emergencies.
<i>Section 5: Form of Control</i>			
Form of control for GDBs.	A weighted average price cap is the most appropriate form of control for GDBs.	No change.  Approach is consistent with the specification of price in the IM determination.	A weighted average price cap will apply to GDBs in accordance with the IMs.
Form of control for GTBs.	A total revenue cap may be the most appropriate form of control for all GTBs.	A total revenue cap is the most appropriate form of control for MDL.  A weighted average price cap is the most appropriate form of control for Vector.	A total revenue cap is the appropriate form of control for both GTBs.

Topic	View in Issues Paper	View in April Discussion Paper	Draft decision
<i>Section 6: Rate(s) of change</i>			
Setting the X-factor.	Total factor productivity (TFP) is the preferred measure of productivity and we proposed to use TFP to inform our decision on the level of an X-factor.	Based on the Economic Insights report, in the absence of any conclusive evidence to the contrary, an X-factor of zero is appropriate for GPBs for the Initial DPP. The report can be accessed via our website. <sup>92</sup>	We do not consider that the currently available evidence, either from New Zealand or overseas, supports an alternative rate of change other than zero at this time.
<i>Section 7: Price under the Initial DPP</i>			
Revenue assessment and application of claw-back.	GPBs should be required to demonstrate compliance using a specified assessment methodology that would ascertain whether or not, and the extent to which, a GPB has increased its weighted average prices (or over-recovered its allowed revenues) by more than the movement in CPI over the period 1 January 2008 to the date when the assessment is made (the CPI Criterion).	Applying claw-back to GPBs is unlikely to be necessary for the Initial DPP.	Claw-back under s 55F(2) of the Act will not be applied to GPBs for the Initial DPP.

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Economic Insights Pty Limited, *Regulation of Suppliers of Gas Pipeline Services – Gas Sector Productivity*, 10 February 2011. <http://www.comcom.govt.nz/2012-default-price-quality-path/>.

Topic	View in Issues Paper	View in April Discussion Paper	Draft decision
Catering for future investment needs.		The IMs (and the option of applying for a customised price-quality path, including the contingent project mechanism under a CPP) ensure sufficient flexibility under a default/customised regulatory framework to cater for the future investment needs of GPBs.	No change.  The IMs and the option of applying for a customised price-quality path, ensure sufficient flexibility under a default/customised regulatory framework to cater for the future investment needs of GPBs.
Regulatory period	The regulatory period for the Initial DPP would start on 1 July 2012.	Preferred position is to start the regulatory period in July 2012 and this will be for a period of 4 years and 3 months.	The regulatory period will start on 1 July 2012 and this will be for a period of four years and three months.
<i>Section 8: Monitoring of Compliance</i>			
Compliance with the price path for GPBs.	Annual compliance would be monitored by comparing the supplier's performance against the cap.	It is appropriate to set the cap as an 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.	An <i>ex ante</i> compliance regime will be applied to GPBs for the Initial DPP in regards to price.
Compliance with the quality standard for GPBs.			An <i>ex post</i> compliance regime will be applied to GPBs for the Initial DPP in regards to the quality standard.

Topic	View in Issues Paper	View in April Discussion Paper	Draft decision
Assessment periods.	The annual assessment period would start on either 1 July or 1 October for each year of the Initial DPP.	Preferred option is for annual assessment periods of 1 October – 30 September to align with the pricing years of most GPBs. This will require partial year compliance for the period July 2012 – end September 2012.	The annual assessment periods will be 1 October – 30 September each year. This will require partial year compliance for the period 1 July 2012 – 30 September 2012.

## APPENDIX B: OVERVIEW OF THE CURRENT LEGISLATIVE AND REGULATORY ENVIRONMENT PERTAINING TO SAFETY REGULATIONS AND STANDARDS APPLICABLE TO THE GAS SECTOR

