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[By email]

Dear Mark

Initial Default Price-Quality Path for Gas Pipeline Businesses – Issues Paper Submission on Sections 1 – 3 and 5 – 9

1. The Commerce Commission (the Commission) published, in April 2010, an Issues Paper on the initial default price-quality path (initial DPP) for gas pipeline businesses (GPBs) to apply under Part 4 of the Commerce Act 1986 (the Act). This submission reflects the views of GasNet on Sections 1 – 3 and 5 - 9 of the Issues Paper. It should be read in conjunction with GasNet's April 30 submission on Section 4 (Form of Price Control) of the Issues Paper. Our submission is structured to address each of the Sections of the Issues Paper in turn.
2. GasNet is a limited liability company owned by Wanganui Gas Limited (WGL) which owns and operates gas distribution networks in Wanganui, Marton, Bulls, Flockhouse and Waitotara located in the Central North Island. GasNet's combined distribution systems are 366 kilometres long, with approximately 10,300 connected consumers.

Section 2: Nature of Gas Pipeline Services

3. GasNet agrees with the Commission's view that it is appropriate to consider gas distribution and transmission as different types of services for the purposes of the initial DPP and to specify separate DPPs. We agree with the analysis presented in Table 3 which sets out key differences between transmission and distribution. We refer the Commission to our previous submission however, and emphasis that we

believe costs structures for transmission and distribution businesses are similar, as gas distributors do not have a relatively high degree of variable costs as suggested in paragraph 4.16 of the Issues Paper. As an infrastructure business, we have a large amount of capital invested in fixed assets that incur ongoing levels of maintenance expenditure and generate significant depreciation and associated return on capital requirements.

4. GDBs operate in an energy market where natural gas is a discretionary energy form, hence committing to investment in infrastructure is required to maintain or marginally grow end-user connection numbers. This investment is heavily front-end loaded without certainty of return, thus currently and in the future the risk of asset stranding will rise and should not be considered “relatively low” in absolute terms or in comparison to transmission.
5. This submission focuses on the distribution sector, rather than transmission, as GasNet does not own transmission assets. For this reason we have not provided comments on the potential attributes of the service quality aspects of gas transmission.

Section 3: Structure of the Initial DPP

6. We agree that the DPP should include price and quality targets, as this is consistent with the Section 52 A Purpose Statement in Part 4 of the Act.
7. GasNet supports separate price and quality paths for Gas Distribution Businesses (GDBs) in the interim (consistent with the DPP for the electricity distribution sector), but in the medium term we believe an integrated price-quality path that explicitly links price and quality is more appropriate. Prices must reflect quality of supply, as these are the two outputs of most relevance to end users. Businesses must be able to recover costs associated with improved quality where it is consistent with consumer demands, without having to resort to applying for customised terms.
8. We believe the Commission should investigate the introduction of an S factor mechanism that would allow a supplier’s pricing allowance to adjust to reflect changes in their quality performance. We understand that the Commission plans to undertake further investigation into this issue for the DPP to apply to Electricity Distribution Businesses (EDBs). We suggest that this planned investigation is expanded to consider how a similar mechanism could be included in both GDB and

EDB DPPs. Although this may not be possible to complete prior to the initial DPP Determination, we would encourage the Commission to progress this work stream with a view to implementing a more integrated DPP as soon as possible.

9. We acknowledge that any analysis of the value of incremental quality improvements would require information which currently is difficult to source. In addition, we note the Commission's concerns with safety and submit that any variance in quality which may be provided for through an S factor mechanism would need to ensure that appropriate safety standards were maintained.
10. We also support the setting of one price constraint and one quality constraint for the purpose of the Initial DPP. This would require each GDB to meet two tests during each assessment period. A single test for price and a single test for quality (the two measures which impact most on end consumers) is sufficient. This would have the effect of minimising compliance costs while meeting the regulatory objectives of the DPP. It would also reduce regulatory uncertainty which we believe would arise if a regulated supplier were required to meet a number of tests in each assessment period, with some probability (due to forecast error, external influences or normal variance) of not meeting all tests all of the time. The DPP is supported by the further performance information provided by the information disclosure regime.

Section 4: Form of Price Control

11. As stated in our previous submission, GasNet believes appropriate incentive regulation should enable it to recover its costs and ensure service quality is maintained, while enabling it to benefit from potential cost reductions, and share those benefits with consumers over time.
12. GasNet supports the application of a weighted average price cap that would allow a supplier of regulated services to adjust its prices irrespective of volumes, subject to an overall price cap. This option adequately accommodates incremental network growth without requiring specific terms to be negotiated.
13. As previously stated, GasNet agrees with the Commission's view that it is appropriate to consider gas distribution and transmission as different types of services for the purposes of the initial DPP and to specify separate DPPs.

Section 5: Pricing Arrangements Prior to the Initial DPP

Process

14. GasNet submits that any analysis by the Commission of whether to apply claw-back should include consideration of actions taken by GDBs to mitigate the effects of, or compensate for, any perceived over recovery of revenue which may be identified under Section 55F (2) of the Act. The Commission should also consider any potential under recovery of revenues over the same period when making an assessment of potential claw-back arrangements. This is consistent with the definition of claw-back contained in Section 52D (1) of the Act.
15. At this time GasNet is unable to comment on whether any potential claw-back should be applied as part of starting price adjustments, as it is not clear what approach would be adopted in order to make such an adjustment, or the potential impact. We also note that Section 52D (2) and (3) of the Act require the Commission to consider and smooth financial and price impacts of any claw-back which may be made.
16. GasNet agrees with the proposal for GDBs to provide their own assessment of whether or not the Section 55F (2) CPI criterion has been met. GasNet also agrees that the timing for submission and completion of such assessments – in the third quarter of 2011 – appears reasonable, assuming the Initial DPP is to be introduced in mid 2012.
17. We also note that the Commerce Amendment Act was enacted in September 2008 however the CPI criterion applies from 1 January 2008. Accordingly this requirement has imposed a retrospective ceiling on gas distribution prices, which was unable to be accommodated or adjusted for within the first assessment period (ie: 2008) given the date of enactment was after prices had been published for the next pricing period, commencing 1 October 2008. Such circumstances must be considered by the Commission in any assessment of the CPI criterion and GasNet cautions against a mechanical application of any potential claw-back assessment formula for this purpose.

Methodology

18. While GasNet agrees with a weighted average price cap approach, it believes that any methodology should assess the weighted average price for the entire regulatory period (1 January 2008 to the beginning of GasNet's annual pricing period prior to the DPP Determination). We do not believe Section 55F (2) requires the Commission to make an annual assessment, and impose a penalty on a GDB which may have a weighted average price increase which exceeds CPI in any one pricing period. In this respect we note that Section 55F (2) requires (emphasis added):

*(2) 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.*

19. Subject to our comments above, GasNet agrees with the Commission's proposed Assessment Methodology approach, namely to compare a GDBs change in weighted average prices with the corresponding change in CPI, using actual CPI data.

20. GasNet agrees with the proposal to use reference quantities for this purpose. Any seasonal influences in the pro-rata adjustment of quantities for the first partial year should be accommodated where prices are a function of consumption or demand. We also support the proposed inclusion of an amendment option in order to provide additional flexibility for demonstrating compliance with the Assessment Methodology. This would accommodate complexities introduced through tariff restructuring for example.

Revenue Assessment and Claw-Back

21. If a GDB exceeds the CPI criterion, the Commission should consider not only over-recovery, but also under-recovery, in its application of the Assessment Methodology. This would provide a more accurate illustration of the net effect on consumers of a possible failure to meet the CPI criterion. Under-recoveries should also be factored into any assessment of opening prices or rates of change in the Initial DPP.
22. It is not possible to comment further on a potential methodology for this calculation at this stage. Input Methodologies have not yet been determined, and we do not yet know what dataset the Commission will have available to it when it sets its Initial DPP. We also do not yet know how starting prices are to be set of the Initial DPP. We do however agree that consideration of actual revenues rather than notional revenues would provide the most accurate assessment of revenue recovery, however this would need to factor in the impact of changes in demand, service levels, consumption, costs, investment and tariff restructuring.
23. GasNet submits that any potential claw-back, whether positive or negative, could be factored into either opening prices or rates of change in the DPP.

Section 6: Productivity Analysis

24. GasNet is broadly supportive of a total factor productivity (TFP) X-factor approach, but there is significant risk to businesses if the X factor is calculated incorrectly. We agree that any outputs of such analysis should not be applied mechanically. We note that TFP analysis is highly susceptible to the quality of the data used and the specification and weightings applied to inputs and outputs and in addition the model specification. These limitations are partly illustrated in Appendix C of the Issues Paper. We have also observed the debate in establishing TFP estimates for EDBs and in particular the divergent views of TFP experts, and draw little comfort from the process.
25. We note that past performance is not necessarily an indicator of future productivity gains. For example, major sector reform such as that imposed on EDBs as a result of the Electricity Industry Reform Act (1998) have historically caused one-off productivity gains that are unlikely to be replicated. Past amalgamations in the gas distribution sector are expected to have generated similar results.

26. Accordingly GasNet has serious concerns with the proposal to effectively replicate the TFP approach adopted for EDBs. We note there was widespread opposition to the approach adopted by the Commission's advisor by EDBs and that considerable effort was required by the regulated businesses to critique the Commission's proposals and provide an alternative study, prepared by TFP experts based in the US. We would not wish to see a similar requirement emerge from the Commission's proposed process for GDBs.
27. We also question whether there is a dataset of sufficient longevity and quality for GDBs which would provide the required inputs for a TFP study. We know EDBs have had a considerably more developed information disclosure regime for many years than that which has existed for GDBs. We acknowledge in principle GDBs should be able to prepare historical data sufficient to meet the Commission's requirements, but we suggest this would only be achieved at quite considerable cost to the businesses, for example we would need to be able to retrospectively strip out of our past disclosures all matters relating to our Gas Measurement System (GMS) business. We also question whether it will be possible to achieve a dataset which is consistent across the sector, for example in respect of asset valuation.
28. GasNet does not believe the use of overseas gas sector productivity growth estimates is relevant for GDBs in New Zealand. The scale of our operation is such that international data is unlikely to be relevant to us.
29. Given the points raised above we suggest the Commission gives serious consideration to setting an X factor equal to 0 for the purpose of the Initial DPP for GDBs, similar to the one which has been adopted for EDBs after two different, but extensive TFP studies were undertaken. Vector and Powerco are the major firms in the gas distribution sector, as is the case in electricity distribution, and we would expect their relative size in both sectors to influence productivity trends in a similar manner. We note however that GasNet is very different in size and scope to Vector and Powerco and it may not be possible for GasNet to achieve the same rate of change as the larger entities.

Section 7: Quality Standards

Quality Indicators

30. GasNet agrees that quality incentives are important within a price control regime, as it can potentially mitigate incentive for suppliers to reduce expenditure to the detriment of service quality and is consistent with subpart (b) of the Section 52A Purpose Statement. Effective quality regulation requires objective quality standards with defined and measurable indicators. We submit the quality measure in the DPP should be a measure of service which best represents the quality service for gas consumers.
31. Accordingly GasNet submits that reliability should be the only quality measure included in the DPP. Other measures may be monitored, as part of information disclosure regulation, however it is appropriate, as has been adopted for EDBs that the DPP focuses on the quality measure of most importance. We believe a SAIDI measure is most appropriate for this purpose as it measures non supply from a consumer's perspective. Consideration needs to be given however to the impact of events external to GasNet which may influence SAIDI performance. We confirm GasNet currently compiles equivalent SAIDI information and has done so for a number of years.
32. We suggest that the DPP should be made up of one quality measure and the weighted average price measure. GDBs should be required to assess compliance with each annually under the Initial DPP. For this reason we do not believe it is necessary to include a SAIFI measure in the DPP. As noted above in our view SAIDI is the best measure of quality for consumers.
33. GasNet does not support the adoption of system integrity, quality of gas, nor customer service measures of quality for GPBs. System integrity is largely outside GasNet's control as it is affected by third party actions such as damage. Unaccounted for gas (UFG) is also largely determined by factors such as third party measurement and emergency events. Quality of gas is predominantly determined at the extraction and processing stage. Customer service (assuming the customer is the end-user) is predominantly the responsibility of the retailer.

Setting Standards

34. We agree the standard should be numeric, and readily defined and calculated. As always we are conscious of compliance costs and wish this burden to be as light as possible. We believe the standard should be set on the basis of a no material deterioration benchmark. That is, it should be based on historical performance with acknowledgement and accommodation of the impact of extreme external events and year on year variation in performance. We understand this approach was adopted when setting the quality component of the EDB DPP.

Section 8: Data Requirements

Data Availability

35. GasNet acknowledges that the information disclosed under the *Gas (Information Disclosure) Regulations 1997* may not provide sufficiently detailed information for the purposes of regulatory decision making. Of most importance however is ensuring the data to be used for the purpose of the DPP is consistent with the Input Methodologies, which are yet to be determined. As outlined previously we do not support a detailed TFP study for GDBs at this time. We do not believe the outputs of such a study will be credible, partly due to the complexity and sensitivity of the TFP models and partly due to the lack of a robust dataset which is able to provide the data required for such a study on a consistent basis for all regulated businesses in the sector.

Data Suitability

36. GasNet agrees that any information required of GDBs would have to be robust, accurate and consistent across the gas distribution sector. Again, we have concerns about the cost to us, as small business in the context of the overall sector, for complex information gathering requirements. We submit that any additional data requirements must be directly relevant, and consistent with the requirements of the Initial DPP.

37. GasNet is willing to provide any data the Commission deems necessary in order to properly inform the regulatory decision making process. However we strongly believe any information gathering obligation for GDBs should be directly relevant to gas pipeline businesses and considered from a least-cost perspective.

Data for Setting the Initial DPP

38. GasNet has a full disclosure dataset available from 1997 onwards, consistent with the “currently disclosed” column in Table 4 of the Issues Paper. This dataset however includes data relevant to unregulated services, as defined under Part 4 of the Act. As GasNet has restructured, revalued and improved its data over this period, there are some step changes in results reported across the time series which would need to be considered in addition to removing non regulated services.
39. If necessary GasNet could provide the additional quality data indicated in the “maybe required” column (PRE and SAIFI) from 2007 onwards.

Section 9: Annual Assessment and Regulatory Periods

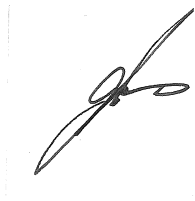
40. GasNet is comfortable with Option 1 (July to June Assessment Period) because this aligns with GasNet’s financial year, although it differs to our pricing year. We would rather the assessments are aligned with our financial year, our disclosure year, the Initial DPP Determination and hence the five year regulatory period. We believe the annual assessment formula can be designed to accommodate a change in prices part way through an assessment period. However, we can also accommodate Option 2 if necessary (October to September Assessment Period).
41. We do not support an approach which would require us to change our pricing year. We have long standing arrangements with retailers to reset our prices on 1 October which aligns with their pricing year. We do not believe it is appropriate for the regulatory regime to impose such a change on the industry.

Other Issues

42. We also note that the Issues Paper does not address how starting prices will be set, how compliance with the Initial DPP will be assessed and the nature of the price and quality assessment formulae which will apply. We look forward to engaging with the Commission on these points as the consultation process develops, although we believe these topics can be deferred until 2011, to allow us to focus on the Input Methodology consultations during the coming months.

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

Yours sincerely

A handwritten signature in black ink, appearing to read 'Geoff Evans', written over a light grey rectangular background.

Geoff Evans

General Manager