

28 September 2011

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[By email]

Dear Mark

Submission on Setting Starting Prices for the Initial Default Price-Quality Path for Gas Pipeline Businesses

1. The Commerce Commission (Commission) has released a Discussion Paper "Setting of Starting Prices for Gas Pipeline Businesses under the Initial Default Price-Quality Path", dated 22 August 2011 (the Discussion Paper). This follows earlier consultation papers on the proposed Default Price-Quality Path (DPP) for Gas Pipeline Businesses (GPBs):
 - The April 2010 Issues Paper on the Initial DPP for GPBs; and
 - The April 2011 Discussion Paper on the Initial DPP for GPBs.
2. Neither of the previous papers addressed in detail how the Commission proposes to set the prices for each GPB at the beginning of the Initial DPP. The August 2011 Discussion Paper addresses this particular issue.
3. GasNet welcomes this further opportunity to engage with the Commission on the setting of the Initial DPP. This submission reflects the views of GasNet on the aspects of the Discussion Paper that are of relevance to our business.
4. 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 386 kilometres long, with approximately 10,300 connected consumers.

5. GasNet is small in the context of the gas distribution sector, particularly relative to the other two much larger Gas Distribution Businesses (GDBs). Our overarching concern in this regard is that the Commission develops regulation that is suited to all regulated GDBs. In particular, it is our concern that DPPs are not overly burdensome or inflexible on GasNet, which is the smallest supplier captured by these requirements.
6. We outline our key submission points below.

Proposed EDB DPP Starting Price Method

7. We understand the proposed approach for setting the Gas Distribution Business (GDP) DPP starting prices has been partly informed by the proposed approach for Electricity Distribution Businesses (EDBs) which is to be shortly finalised. Indeed the Commission specifically requested that GPBs consider its April 2011 consultation with EDBs in the context of the proposed GPB DPP. GasNet responded to this request in our 30 May 2011 Cross-Submission on the “2010-15 Default Price-Quality Path Starting Price Adjustments and Other Amendments, Update Paper”.
8. A number of the points we raised in our Cross Submission are relevant also to this recent Discussion Paper. We trust the Commission has considered our earlier submission, and we encourage you to reconsider the points we have already made when further developing your proposed method for GPBs. Where appropriate we have referred to our Cross Submission throughout the remainder of this submission.
9. In addition, we note the judgement released earlier this week in Vector Limited v Commerce Commission, which found in favour of Vector’s appeals against the Commission’s proposed approach to starting price adjustments for EDBs. The judgement is to apply equally to GDBs. We have not at this stage considered how this may affect GasNet, nor have we formed a view on how this decision should be reflected in the price-quality regulation to apply to our business.
10. The remainder of this submission sets out responses to the Discussion Paper, which were prepared before the judgment was made.

DPP Intended to be Low Cost

11. The Discussion Paper highlights the low cost intention of a DPP with reference to section 53K of Part 4 of the Commerce Act (1986):

53K Purpose of default/customised price-quality regulation

The purpose of default/customised price-quality regulation 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.

12. We support the intention for DPPs to be relatively low cost. We believe this can be achieved by ensuring DPPs are set following robust consultation, supported with models, data and assumptions which are fit for purpose. If regulated suppliers are required to apply for a Customised Price-Quality Path (CPP) to correct deficiencies in either the consultation process or the models, data and assumptions used to set either the price path or quality standards, we consider the low cost objective will not have been met. We expressed our concerns in this regard in our Cross Submission and refer the Commission to our supporting explanation included in that document.¹

13. In this respect we are concerned at the Consultation Process to date, in particular with respect to the starting price component of the GDB DPP. Our Cross Submission raised concerns about the information which may potentially be required to set starting prices for GPBs.² We noted the differences between the EDB historical and forecast dataset and the one which is available for GPBs. We therefore submitted:

.... that the Commission must issue a proposal for a SPA method for GPBs for consultation which specifically addresses the circumstances relevant to the gas sector including the regulatory provisions (both current and past) and the information requirements. This must be consulted upon prior to any information request for SPA data. It is not appropriate to assume that EDB consultation is

¹ Refer our 30 May 2011 Cross Submission "Submission on Proposed DPP Starting Price Adjustment Method", paragraphs 4 and 5

² Ibid, paragraphs 6, 7 and 8

sufficient for GPBs. We must be able to consider a specific proposal for our sector before a determination is made.

14. Unfortunately an information pack was issued shortly after, prior to any consultation about the proposed method to apply to GPBs. This suggests the Commission may have already determined its approach given it has already collected the data it believes it requires. The Discussion Paper also refers to the possibility of commissioning independent experts to develop necessary projections. We find this somewhat concerning given these submissions are due at the end of September, and the Commission intends to publish its draft decisions in early November. There seems to be insufficient time permitted for adequate consideration of the views of interested parties on the proposed approach before the Draft Decision. The consultation timetable does not seem to allow for the Commission to implement any other than its proposed approach.

15. We note that Vector has submitted that there is not sufficiently robust data available in relation to gas distribution and transmission for the purpose of setting prices on the basis of current and projected profitability.³ We are sympathetic to this view and the suggestion that the Initial DPP should start with existing prices (ie; those already in place at the beginning of the Initial DPP). This is consistent with the alternative option available to the Commission via section 53P(a). It is further enhanced by the section 55F(2) CPI limits to price increases for GPBs since 1 January 2008.

16. We note the proposed approach is for the Commission to forecast its estimates of costs and revenues for each GPB and to set starting prices to solve for a “normal” level of returns over the DPP period. The proposal is heavily reliant on the forecasting assumptions. Some of the forecast data required is not readily available to the Commission at this stage, some proxies are proposed (for example historical trend data) and other data may be independently commissioned. We are concerned that the Commission proposes to set the starting prices using a model for which the required inputs and assumptions are not available. This is potentially harmful to businesses and consumers as it may result in unreasonable forecasts. This places regulated businesses in an unfortunate position of potentially having to apply for a CPP to correct the forecast error. In our view this option should not be

³ Refer Vector Limited, Initial Default Price-Quality Path for Gas Pipeline Businesses – Submission, 27 May 2011, paragraph 22

required for those businesses which are expecting to operate in a business as usual manner during the DPP regulatory period. Given the required information is not available, GasNet submits the Commission should either:

- Develop a different model, where the required information is available; or
- Set the Initial DPP in accordance with section 53P(a) and gather the necessary information to apply the proposed model at the next reset.

17. The remainder of this submission addresses the proposed starting price approach, notwithstanding our support for Vector's suggestion to use the section 53P(a) provisions to determine the starting prices for the Initial DPP.

Information Requirements

18. It is proposed the starting prices will be set with reference to actual data for the 2009/10 period (consistent with the s53ZD Information Request) and assumptions concerning projected growth rates for each supplier's capex and opex, and for GDBs, real revenue growth rates.

19. As the Initial DPP is to commence in 2012, and the decision must be made four months in advance to allow it to be factored into prices, it will not be possible to use actual data for the 2011/12 period to inform the starting prices for the Initial DPP for the proposed approach. We understand the initial information request for 2009/10 data was partly in response to submissions that audited 2010/11 data was not readily available at the time the request was made. However given the importance of the base year for the purpose of determining projected profitability we submit that 2010/11 data should also be used. This would remove one potential source of forecast error which may arise where the Commission's 2010/11 forecasts deviate from 2010/11 actual performance which is now known.

20. At the most simple level, 2010/11 data for capex, opex and revenue should address most of the significant sources of potential forecast error. This would avoid a repeat of the full s53ZD dataset for the 2010/11 period.

21. In respect of the forecast assumptions, we are aware that there has been considerable debate concerning the suitability of the forecast assumptions and

data sources the Commission proposes to use for the EDB DPP. We understand this is still to be finalised, just three weeks from the date of the final decision.

22. We acknowledge the recent communication from the Commission regarding expected future insurance costs. We are currently seeking advice from our insurance providers as to the expected rate of change in our premiums over the next few years, and will provide that information to the Commission in due course. In the interim however we can advise the Commission that our network insurance premium next year is expected to be 160% higher than it was last year. Our previous insurer has withdrawn from the market, and we have had to seek a new provider, at a significant cost increase.

23. In particular, in respect of the proposed assumptions for GDBs, we have the following concerns.

- *Regional growth assumptions.* It is proposed GDP, population (and possibly throughput) assumptions are sourced from a range of regional forecast datasets. For GasNet it is proposed that forecasts for the Manawatu region are used. GasNet's supply area is limited to the Wanganui City region and the smaller urban centres of Marton, Bulls, Flockhouse and Waitotara. This is a vastly different footprint to the Manawatu region. Importantly, our supply area does not benefit from the level of economic activity enjoyed throughout the Manawatu, particularly Palmerston North city which is considerably larger. Accordingly we believe that regional assumptions should be applied using Territorial Local Authority areas, rather than regional boundaries. This would permit the Commission to use its independent forecasts while meeting its low cost objectives by ensuring the data is fit for purpose.
- *Variable throughput growth rates should only apply to relevant customer groups.* As a small network GasNet's revenue is heavily influenced by the larger customers we supply. Where those customers do not contribute to variable revenues, their throughput data should be excluded from the analysis of throughput growth rates. Over the past four years, our standard customers, those which incur a variable charge, have contributed 39%, 40%, 36% and 30% respectively towards total throughput volume. The remaining throughput has no impact on revenue growth as it is not subject to a variable charge.

- *Fixed revenue growth is not driven by population.* Gas supply is a discretionary service. GasNet’s supply area has a high level of penetration into the mass market (we do not distinguish by end use such as residential or commercial) and future growth prospects are limited. The following table illustrates our existing connection mix.

Capacity (m ³ /hr)	Connections		Consumer Type
	Number	%	
Up to & including 12	9852	98.4%	Residential & small commercial
Over 12 & up to 30	82	0.8%	Medium commercial & small industrial
Over 30 and up to 150	67	0.7%	Large commercial & medium industrial
Over 150	12	0.1%	Large industrial
Grand Total	10013		

It is proposed that the population growth rates for the Manawatu region are used to determine population growth rates for GasNet’s supply area. A ratio of households/connections is to be used to establish an uptake ratio. An estimate of household growth is to be made from population projections, and uptake growth calculated accordingly. A different but yet undetermined approach is to be used for commercial and industrial consumers. We do not support any approach which distinguishes by end use. We are a transportation network, and the size of the connection and basis of charges consistent with the demands of our connections are of most relevance. While population may be an appropriate driver for electricity connection growth we do not support it for GPBs. Factors such as the level of existing penetration, and the socio-economic characteristics of the population are more relevant.

- *Large capacity connection charges reflect investment cost.* The revenue received from our largest connections reflects the cost and maintenance of the assets invested in supplying those services. There is no real growth in that revenue and suggestions that capacity and population growth could be used to project real growth in this source of revenue are not supported. It is unreasonable to expect that GasNet would increase its capacity or large customer fixed revenue at a rate consistent with the regional (Manawatu) GDP growth rates. New large connections are rare for GasNet, unlike for the larger networks.

- *Industry specific indices are more relevant than industry wide price indices* – we have typically used the CGPI-Pipelines sub-sector index when undertaking valuations and capex projections. We consider this vastly more suitable for projecting capex price inflation than an all industry index as is proposed. We also believe that the Electricity, Gas, Water and Waste Services Labour Cost Index is more suitable for projecting labour cost input price inflation than the all industries index as proposed. This is more likely to reflect the demand for the skilled inputs we require in our business, and the associated cost of providing those services. We are comfortable with the proposed 60:40 weight for labour and material price inflation for opex.
- *Capex growth rates.* We are concerned at the assumption that historical capex trends are a relevant basis on which to estimate future capex trends. We note this is a departure from the approach to be applied to EDBs where capex growth rates are extracted from the capex forecasts of each entity. The reluctance to use GPB forecasts seems to be based entirely on the lack of published Asset Management Plans (AMPs) for GPBs. We do not believe this is sufficient justification for this change in approach. We have not been asked for our capex (or opex) forecasts. We could readily provide this data if required. We don't believe the lack of a publicly available AMP is sufficient justification for using historical data. There is no reason why historical capex is a reasonable predictor of future capex. The proposal to use historical capex is also inconsistent with the proposal to use forecast growth rates for capacity and fixed revenue. Additional demand and new connections are key drivers of the rate in change in capex. If the Commission is not comfortable with the forecast information available from GPBs, then we suggest the Commission further considers Vector's suggestion that the Initial DPP is set with reference to existing prices, and that information is gathered during the Initial DPP to inform a price reset at the beginning of the next period.

Reasonableness Tests

24. The Discussion Paper indicates that the Commission believes that it is inappropriate to include a margin to allow for uncertainty in the projections as consumers are likely to bear the costs of higher prices associated with a margin. However consumers will also bear the costs of poor regulatory decisions, either in terms of the costs of applying for a CPP, or the costs of underinvestment that may result if prices are set too low. This is likely to occur if businesses such as GasNet

are not willing to enter into the CPP process (which as we have said a number of times involves processes which are unreasonable and hence prohibitive for a business of our size).

25. Given the relatively poor dataset the Commission has available to it, and the number of relatively ad hoc assumptions it must make in order to implement its proposed projection model, we suggest further consideration of a margin for error should be made. We believe this is consistent with the low cost intent of DPP regulation.

26. In addition, we suggest that should the Commission determine that forecast costs and revenues do not align, and therefore on face value an adjustment to starting prices is required, the following should be considered before any step change is implemented:

- Whether current profitability is consistent with “normal returns”; and
- How material is the estimated differential between projected costs and revenues.

27. These considerations may lead to a reasonable conclusion that no adjustment is made at this time where, existing returns are broadly consistent with the Commission’s view of normal returns and projections support this, particularly in the near term. We note that section 53P(3)(b) requires consideration of *current and projected* profitability. We believe the proposed approach is unreasonably biased towards projected profitability.

28. We do not believe adjustment should be made based on a projected trend over time which moves away from a normal, or near normal level of returns. The proposed forecast basis is simply not robust enough and any forecast error is likely to compound over time. The near term information should carry more weight in the decision whether or not to change starting prices.

29. The Discussion Paper indicates that reasonableness checks will be undertaken to compare forecast with historical data. We are aware of considerable discrepancies between historical and forecast data in the EDB Draft Decisions which have not been addressed. We also note that the historical dataset available to the Commission is not consistent with the scope of the regulated service for GPBs to

be captured within the DPP (ie: it includes GMS services). We suggest historical cross checks (for example in respect of opex) will be meaningless.

Alternative Rates of Change

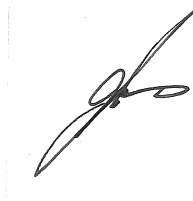
30. We suggest it is too early for the Commission to lock in its proposed approach for implementing the starting prices for the Initial DPP. Currently there is no understanding of the likely magnitude of such changes, or indeed whether any such changes are required at all.

31. As noted above gas supply is a discretionary service, operating in a highly competitive market with readily available substitutes. Gas supply businesses are therefore constrained by the market in how prices are set, and the rates of change able to be implemented. Each gas supply business understands its customer base and therefore is best placed to manage any transition to a new revenue requirement which may be imposed by the Initial DPP. We therefore do not support the proposed 10% threshold for the alternative rates of change. The proposed alternative rates of change should be available to all suppliers, on the basis that they can be implemented in a NPV neutral manner which best suits the market in which they operate.

Closing Remarks

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

Yours sincerely

A handwritten signature in black ink, appearing to be 'Geoff Evans', written over a faint rectangular stamp.

Geoff Evans
General Manager