



COMMERCE COMMISSION

**Authorisation for the Control of Supply of Natural Gas Distribution Services by Vector Ltd and Powerco Ltd Process Paper (Amended)
&
Consultation on Consideration of Amending Provisional Authorisation**

2 June 2006

Purpose

1. This Paper has two sections. Section One describes the Commerce Commission's (Commission) proposed approach for issuing the final determination for the authorisation (Final Authorisation) of the supply of gas distribution services by Vector Ltd (Vector) and Powerco Ltd (Powerco). The approach has been revised following a review of the process and work streams to date. Please note that this amended process replaces the process previously described in the Process Paper dated 24 January 2006¹.
2. In light of this revised process, the Commission is considering whether to make amendments to the Provisional Authorisation. Section Two of the Paper discusses whether to amend the Provisional Authorisation, and describes the issues the Commission would consider in deciding whether to make any amendments. Submissions on this matter are requested by **19 June 2006**.

Background and Legislative Context

3. On 27 July 2005 the Minister of Energy announced the decision to impose control over the gas distribution services of Powerco and Vector (businesses). The Minister made this decision based upon, among other advice, the recommendations of the Commission in its Gas Control Inquiry Final Report². Control was implemented by way of an Order in Council³, and took effect on and including 25 August 2005.
4. The Order in Council defined the gas distribution services to be subject to control as being the line function services and metering services (the controlled services).

¹ Commerce Commission, Authorisation for the Control of Supply of Natural Gas Distribution Services by Vector and Powerco Process Paper, 24 January 2006.

² Commerce Commission, Gas Control Inquiry Final Report, 29 November 2004.

³ Commerce (Control of Natural Gas Services) Amendment Order (Order in Council) 2005, gazetted 28 July 2005.

Sections 70 to 72 of Part 5 of the Commerce Act (the Act) provide for authorisations, provisional authorisations and alternative undertakings, which may be imposed following a declaration of control.

5. On 24 August 2005, pursuant to section 71 of the Act, the Commission issued a provisional authorisation specifying the control terms for the supply of the controlled services by Vector and Powerco, to enable the controlled services to be lawfully supplied on and after 25 August 2005. Section 71 of the Act allows the Commission to issue a provisional authorisation pending a final determination under section 70 of the Act.

6. Subsection 70(1) of the Act empowers the Commission, using whatever approach it considers appropriate, to make an authorisation regarding all or any component of the prices, revenues, or quality standards that apply to the supply of the controlled services. The approach may include the use of formulae or other methods from which prices or revenues may be determined. The Commission may authorise different prices, revenues and quality standards to meet different circumstances.

7. In exercising its powers in reaching a decision on the final authorisation, s 70A of the Act states that the Commission must have regard to -

- (a) the extent to which competition is limited or likely to be lessened in respect of the controlled goods or services;
- (b) the necessity or desirability of safeguarding the interests of persons who acquire (whether directly or indirectly) or supply the controlled goods or services;
- (c) the promotion of efficiency in the production and supply or acquisition of the controlled goods or services.

8. Under s. 70B, the Commission is also required to follow a particular administrative procedure in reaching decisions about the nature and form of control for the final authorisation. As part of that process, the Commission must have regard to any submissions made by acquirers and suppliers. The suppliers of the controlled services are Powerco and Vector. There are many acquirers of the controlled services; these are the relevant gas retailers, the large industrial gas users, small business consumers and residential consumers who are supplied from Powerco's and Vector's gas distribution networks.

9. Under s. 70C (1) the Commission may impose, as part of an authorisation, provisions for remedies and penalties that apply if –

- (a) the prices determined by the Commission in an authorisation are lower than any price charged to any person under a provisional authorisation;
- (b) higher prices are charged, or higher revenues are derived, than those allowed in an authorisation;
- (c) quality standards are breached.

Section One: Amended Process for issuing Final Authorisation

10. This section describes the process that the Commission proposes to follow in reaching its decision on the final determination.

Process and Timetable

11. The following table summarises the steps the Commission has taken to date, and the steps it proposes to follow to reach its decision on the final determination. The intention is for the final determination to be published by 4 May 2007.

Period	Steps
25 October 2005	Commission issued Invitation for Expressions of Interest.
17 November 2005	Commission issued Proposed Process Paper.
25 November 2005	Commission sought asset valuation information from businesses.
8 December 2005	Comments on Proposed Process Paper received.
20 January 2006 30 January 2006	Commission sought operating expenditure, capital expenditure and quality information from businesses. Commission issued Asset Valuation Methodology Discussion Paper.
27 February 2006	Submissions on Asset Valuation Methodology Discussion Paper received.
30 May 2006	Commission publishes revised process paper and consults upon possible amendments to Provisional Authorisation.
19 June 2006	Deadline for Submissions on consultation on possible amendments to the Provisional Authorisation.
30 June 2006	Commission initiates asset valuation process.
3 July 2006 31 July 2006	Commission releases Form of Control Discussion Paper for consultation. Submissions due on Form of Control Discussion Paper. Possible Amended Provisional Authorisation issued.
15/16 August 2006 25 August 2006	Conference on Form of Control. Cross submissions required on Form of Control submissions.
4 September 2006	System fixed assets valuation to be completed.

mid December 2006	Draft Decision Paper to be issued.
early Feb 2007 mid February 2007 late February 2007	Submissions on Draft Decision Paper. Conference on Draft Decisions. Cross submissions required.
4 May 2007	Final Authorisation to be issued.

Comment on Process

12. The Commission has separated the process towards preparing a final authorisation into two broad work streams:

- The development of the form of control framework and methodologies to be applied for the final determination; and
- The identification of the input data (e.g., the costs and forecasts) to be fed into the form of control framework.

This approach is similar to the process followed by the Commission in the Gas Control Inquiry. The Commission does recognise that there is some overlap between these two broad work streams and there is a need for them to be properly sequenced.

13. The development of the form of control framework will proceed through the release of a discussion paper, along with the request for submissions and a conference on that paper. The discussion paper is expected to cover:

- The economic and legal framework for the final determination,
- Analysis on the appropriate form of control for Vector's and Powerco's controlled services,
- Analysis on the appropriate pricing structures and the duration of control.

The Commission now intends this discussion paper will be issued in early July 2006.

14. The formulation of inputs for the form of control work stream addresses the determination of the businesses' allowed efficient costs and quality standards to factor into the form of control methodology. This covers:

- establishing appropriate values for the regulatory asset base and asset life/depreciation profiles;
- verifying forecast operating expenditure;
- verifying forecast capital expenditure;
- determining the appropriate cost allocation methodologies for allocating common costs among the businesses' regulated and non-regulated businesses;
- determining appropriate Weighted Average Cost of Capital numbers for the two businesses; and
- determining quality and reliability standards.

15. The Commission will make use of its information gathering powers in the Act (sections 70E and 98) to assist it in obtaining information relevant to the determination of the authorisation.

16. The two work streams will come together towards the end of the process through the release of a draft Decision Paper for consultation. The Paper will explain the Commission's proposals for setting the terms of the final authorisation for the controlled services.

Other Considerations

Undertakings

17. Under s. 72 of the Act, the Commission may, instead of making a final determination, obtain or accept a written undertaking in respect of the controlled services. The Commission must have regard to the considerations outlined in s. 70A in accepting an alternative undertaking. An undertaking may include provisions for remedies and penalties for overcharging or for breaches of quality standards.

Possible Thresholds Regime

18. The Minister of Energy also announced on 27 July 2005, that a thresholds regime for all gas pipelines businesses would be introduced. This is something the Commission will be mindful of during the final authorisation process.

History

Proposed Process Paper

19. On 17 November 2005, the Commission issued its Proposed Process Paper outlining the proposed process for issuing the final determination for the authorisation of the supply of gas distribution services by Vector and Powerco.

20. Submissions on the proposed Process Paper were due on 8 December 2005. Two submissions were received, from Vector and Powerco. The submissions have been posted on the Commission's website: www.comcom.govt.nz.⁴

21. The submitters both had concerns with the overall timeframe allowed in the process for determining final authorisations. Powerco raised concerns about the contractual timeframe required to consult with retailers, should a change in tariffs occur.

22. Powerco's submission raised concerns that the interim timeframes should be more precisely detailed, that there should be an allowance for cross submissions, that the form of control ('how to') work stream needs to be sufficiently advanced before the information requirements can be defined; and that it would be indicative of a predetermined outcome to define the information requirements ahead of the consultation on the form of control. Powerco also stated its overriding concern as

⁴ <http://www.comcom.govt.nz/RegulatoryControl/GasPipelines/submissionsandconferencetranscripts.aspx>.

being “that the proposed process is premature in light of the substantial challenges Powerco has initiated in its Judicial Review”.

23. Vector’s submission noted the proposed process does not specifically allow for consultation on the final authorisation.

24. The Commission agreed that interim timeframes should be more precisely outlined and that a cross submission process should be provided for following consideration of submissions on the form of control and asset valuation methodology. The 1 September 2006 final determination target date was left unaltered as it was considered that the process would be completed to align with the annual contract date for distribution service contracts with retailers.

25. The Commission considers that it should continue with its statutory function of making a final authorisation despite Powerco's application for judicial review. The Commission considers that the judgment of Justice Young in *Unison Networks Limited v Commerce Commission and Anor*⁵ supports this view. In that judgment Justice Young acknowledged that regulatory processes could be distorted if the courts insist that a challenge to one step in a statutory procedure must be fully resolved before any subsequent procedural steps can be completed

Process Paper dated 24 January 2006

26. On 24 January 2006 the Commission issued a Process Paper, having considered the submissions received, subsequent to issuing the Proposed Process Paper. This reflected indicative timeframes towards issuing a final authorisation on 1 September 2006.

Process Paper dated 30 May 2006.

27. The current Process Paper has been prepared to reflect amended indicative timeframes of the various steps in the process toward issuing a final authorisation, and a revised date of 4 May 2007 for publishing the final authorisation.

⁵ Court of Appeal, CA 161/05, 24 August 2005.

Section Two: Possible Amendments to the Provisional Authorisation

28. In light of the decision to extend the proposed timeframe for the Final Authorisation, the Commission is now considering whether to amend the existing Provisional Authorisation. The Commission may amend provisional authorisations issued under section 71(1) of the Commerce Act 1986. This follows from the combination of sections 71(2) and 70F(1) of the Act.

29. If the Commission decides to amend the Provisional Authorisation, then it is intended that the amendments would take effect from 1 October 2006, the date when the businesses introduce revised prices for the forthcoming year.

30. In summary, the Commission considers there are three reasons for making amendments to the Provisional Authorisation:

- To further adjust allowed revenue;
- To modify the terms relating to quality standards; and
- To improve the application of the Provisional Authorisation.

Background

31. Section 55 of the Commerce Act requires that no person may supply controlled goods and services unless an authorisation under section 70 or 71, or undertaking under section 72 has come into effect. In order to continue the supply of gas pipeline services by Vector and Powerco (the controlled businesses), the Commission issued a Provisional Authorisation under section 71, to commence on 25 August 2005.

32. The key terms of the Provisional Authorisation are:

- for the period from 1 October 2005 to 30 September 2006, the maximum allowed revenue that the businesses can earn for the services being supplied at 1 October 2005 is the sum of the price of each service as at 30 June 2005 multiplied by the base reference quantity corresponding to that price, adjusted by an X factor;
- the X-factor for Powerco is 9%, and for Vector is 9.5%;
- the businesses must define the quality standards applicable to the controlled services, and demonstrate that there has been no material deterioration in the quality of the controlled services since the commencement date;
- for any new non-standard contracts (i.e., where the price and terms are not determined solely by reference to publicly disclosed terms and conditions) since the commencement date, the businesses must provide evidence that demonstrates why it is more advantageous to the customer than a standard contract; and explain why the terms of that new contract is consistent with, or more advantageous to, comparable non-standard contracts.
- For each annual period after 30 September 2006, the maximum allowed revenue for the services being supplied is the sum of the price of each service at 30 June multiplied by a base quantity corresponding to that price. The initial P_0 adjustment will continue to be in effect.

33. These terms of the Provisional Authorisation will remain in effect, subject to any amendments, until such time as it is replaced by a final authorisation (or acceptance of an undertaking).

Issues to be Considered

34. In deciding whether or not to make any amendments (and the nature of those amendments), the Commission will take into account the issues listed below. The Commission acknowledges that there may be other matters that may also be relevant considerations for the purposes of completing the Amended Provisional Authorisation.

35. In deciding whether to make any amendments, the Commission will try to strike an appropriate balance in respect of the interests of all those who will be affected by any amendments.

Findings of the Gas Control Inquiry

36. The Commission will have regard to the conclusions it made in the Gas Control Inquiry Final Report (29 November 2004). For Powerco, the Report stated that the Net Acquirers Benefit⁶ Annuity from having control imposed was \$3.719m; for Vector, the Net Acquirers Benefit Annuity from control was \$6.921m.

Submissions made to the Minister

37. The Commission will consider the submissions made by interested parties to the Ministry of Economic Development on the Commission's Gas Control Inquiry Final Report. In Vector's submission to the Minister, it identified a mistake in the Commission's calculations. The effect of that mistake was to increase the Net Acquirers Benefit Annuity from control for Vector from \$6.921m to \$8.484m.

Oversight in the calculation of tax allowance in the Gas Control Inquiry findings

38. Following the publication of the Final Report, the Commission identified that calculation of the Net Acquirer Benefit did not take into account the true tax allowance. The error was that as a reduction in the excess returns under control will reduce the controlled business' revenue, it will also reduce the business' tax obligations under control. Consequently, a controlled business should be able to further reduce their revenues by an amount equivalent to the reduction in tax payable due to control, and this reduction in revenue should also flow through to consumers in terms of lower prices.

39. Adjusting for this would increase the Net Acquirer Benefit Annuity from Control figures significantly, if the full effect of the mistake was taken into consideration (table 1).

⁶ Net Acquirer Benefit is defined in Section 4 of the Gas Control Inquiry Final Report.

Table 1: Net Acquirer Benefit Annuity from Control	Gas Control Inquiry final Report	With tax calculation mistake
POWERCO	\$3,719m	\$5,228m
VECTOR	\$6.921m (\$8.484m)	\$13,393m

Impact of the Provisional Authorisation on the businesses' revenue

40. As explained in the above background section, the Provisional Authorisation reduces Powerco and Vector's allowed revenue by 9% and 9.5% respectively. That reduction will continue through the next year. The Commission will consider how that reduction has affected the businesses revenue and their ability to earn excess returns as identified in the Final Report.

New forecasts of costs and volumes from the businesses

41. As part of the work for the Final Authorisation, the Commission requested new forecasts of operational and capital expenditure, volumes and connections from the businesses. The Commission has not yet reached any views on these new forecasts but notes that there are some significant differences in these new forecasts compared to the forecasts used in the Gas Control Inquiry calculations. Both businesses are forecasting lower volumes and connections and higher costs. The Commission will assess and verify these forecasts as part of its determination of the efficient costs and prices for the Final Authorisation.

Section 70 C

42. Section 70C of the Act enables the Commission, as part of a final authorisation, to impose provisions for remedies and penalties that apply if the prices determined by the Commission in that final authorisation are lower than any price charged to any person under the provisional authorisation.

Duration of Amendments

43. The Commission is now proposing to issue the final authorisation in May 2007. If the Commission were to make any amendments to the Provisional Authorisation, it is expected that those amendments would apply from 1 October 2006. The Commission will consider whether the benefits of making any amendments for this short duration outweigh any costs associated with making those amendments.

Possible Amendments to the Provisional Authorisation

Further X factor adjustment to allowed revenue

44. The extent of any further X factor adjustment to allowed revenue will depend upon the weights that the Commission places on each issue under consideration. In deciding the extent of any adjustment, the Commission will try to strike an

appropriate balance in respect of the interests of all those who will be affected. The Commission also notes that the current Provisional Authorisation does not adjust allowed revenue for inflation (CPI).

Provisions relating to the regulation of quality

45. Under the Provisional Authorisation, the businesses were required to define the quality standards applicable to the controlled services, and to demonstrate that there has been no material deterioration in those quality standards since the commencement date. Powerco defined compliance with Gas Regulation Standards and Publicly Reported Escapes of Gas (PRE) as quality standards for their networks. Vector proposed to use PRE to demonstrate compliance with the terms of the Provisional Authorisation.

46. The Commission is reviewing the quality of the businesses as part of the Final Authorisation work. There are further possible dimensions to quality than those standards defined by the businesses. Furthermore, the Commission's preliminary review is highlighting problems with how the businesses measure and record quality on their networks. These problems could affect the ability to effectively regulate quality under the Final Authorisation. Amendments to the Provisional Authorisation could address some of these concerns.

Definition of Quantity under the Provisional Authorisation

47. The Provisional Authorisation requires that the maximum allowed revenue that the businesses can earn for the services being supplied as at 1 October 2005 is the sum of the price of each service as at 30 June 2005 multiplied by the base reference quantity corresponding to that price, less the P_0 adjustment. The reference quantity allows the prices to be weighted so that the business cannot manipulate an average price by setting a high price for those services that have the greatest volumes.

48. The reference quantity ($Q_{i,t}$) of the Provisional Authorisation is defined as being the actual quantity for the calendar year to 30 June, or if the service or price has not been in effect for the entire year then the actual quantity to 30 June should be annualised. In its Provisional Authorisation Compliance Statement Powerco expressed its concern that the definition creates an ongoing problem for the businesses as they will introduce the new pricing at the 1 October pricing change date.

49. This means that the volumes that are used to determine the reference quantity will only be those from 1 October to 30 June, and do not take into account the heavy residential gas use in July, August and September. Powerco argue that the allowed revenue for these customers is understated due to the peak months being excluded. As residential customers have the most expensive variable charges, this could be a significant amount. It could be addressed by changing the definition of ($Q_{i,t}$) such that if only the price for the service has changed then the volume for the previous twelve month period (June to June) could be used as the reference quantity.

Request for Submissions

50. Regarding the possibility of making amendments to the Provisional Authorisation, the Commission seeks submissions on:

- The issues the Commission proposes to consider, as set out above.
- Whether there are other issues that the Commission should consider in deciding whether to amend the Provisional Authorisation
- Whether the Commission should amend the Provisional Authorisation, and if so, in what areas?

Written submissions on these questions should be received by the Commission by no later than **19 June 2006**. All submissions should be supported by documentation and evidence, where appropriate.

To foster an informed and transparent process, the Commission intends to publish all submissions received on its website (www.comcom.govt.nz). Accordingly, the Commission would appreciate an electronic copy of each submission. The Commission requests that hard copies of submissions not be provided to it, unless an electronic copy is not possible. Submissions should be sent to:

Network Performance Group
Commerce Commission
P.O. Box 2351
Level 6, 44-52 The Terrace
Wellington

E-mail: gas@comcom.govt.nz

Next Steps

51. Following a review of the submissions received on this Paper, the Commission will decide whether to proceed to making any amendments. If so, the Commission will then consult on any draft amendments. The Commission will aim to finalise any amendments in time for the businesses' notification of October 2006 prices to retailers. The Commission understands that the businesses must give 60 days notice of any price changes and hence that amendments to the provisional authorisation should be in place in sufficient time for 1 August 2006.