

9 August 2010

Dr Mark Berry
Chair
Commerce Commission
P O Box 2351
Wellington

[By email]

Dear Mark

Input Methodologies (Gas Pipeline Services) Draft Reasons Paper and Draft Determinations

1. This submission has been prepared in response to the Commerce Commission's (the Commission's) Input Methodologies (IM) consultation pursuant to Part 4 of the Commerce Act 1986 (the Act) which provides for the regulation of gas pipeline businesses (GPBs) and other services. In it GasNet addresses issues raised in the Commission's Paper: *Input Methodologies: Gas Pipeline Services: Draft Reasons Paper (June 2010)* (Draft Reasons Paper) and the associated draft determinations and accompanying expert reports.
2. As previously submitted GasNet's overarching concern with the application of the new regulatory regime and the associated IMs is that compliance costs are fair and reasonable. GasNet is a relatively small GPB, and any increase in compliance costs will have a material effect on our business. In our view it is questionable as to whether these additional costs, which ultimately will be borne by consumers, will be outweighed by any potential benefits of the extended regulatory regime.
3. GasNet also operates a business in a competitive market (gas metering (GMS)) and we have concerns that increased levels of regulation and compliance costs may indirectly impact on this business.

4. This paper addresses the Commission's draft decisions as they are set out in the Draft Reasons Paper. We have considered each of the Draft Determinations when preparing our submission however we have not included detailed mark ups of the Draft Determinations with our submission, primarily due to the level of resources required to undertake such a task effectively, which we are unable to commit to.
5. Our submission is also limited to those decisions which affect gas distribution businesses.
6. We first address the overall regulatory framework and then each of the IMs in turn as follows:
 - A. Cost Allocation
 - B. Asset Valuation
 - C. Treatment of Taxation
 - D. Cost of Capital
 - E. Pricing Methodologies
 - F. Rules and Processes
 - G. Customised Price-Quality Paths.

Regulatory Framework

7. We are concerned that the draft determinations do not set out regulatory mechanisms to apply to GPBs which adequately reflect the intention of the amendments to Part 4 of the Commerce Act (the Act), that is to improve regulatory certainty and to provide cost effective regulatory solutions for suppliers of regulated services.
8. In particular we believe the Commission is required to develop each of the regulatory mechanisms to apply to GPBs in order to:
 - Provide an information disclosure regime to enable interested parties to assess performance of regulated suppliers against the section 52A Purpose Statement;
 - Provide a relatively low cost regulatory mechanism for limiting prices and establishing quality standards consistent with the section 52A Purpose Statement (the DPP) (Section 53K); and

- Provide an alternative option for regulated suppliers to apply for more customised price and quality standards in order to meet specific needs unable to be accommodated in the DPP (a CPP) (Section 53K).
9. Accordingly we believe that the DPP and CPP should be designed on the basis that:
- The DPP should apply to most regulated suppliers most of the time, and therefore provide realistic price and quality standards which ensure businesses invest sufficiently to meet current and future demand for the regulated service; and
 - The CPP should be a realistic option for regulated suppliers (from time to time), seeking to manage future circumstances not adequately addressed by the DPP.
10. In order to achieve this, the DPP must be able to accommodate external events which impose additional costs or adverse impacts on quality which are outside the control of the supplier. In addition the CPP option must not be unduly risky, complex or expensive to undertake. For the DPP to achieve its intended purpose, the CPP option must exist as a realistic option for all suppliers. Currently we do not believe this is the case for small suppliers such as GasNet.
11. Accordingly, in order to achieve the objectives set out above we believe the following amendments are required to the Commission's proposed approach:
- The circumstances under which the DPP is reopened are broadened to include external and unforeseen events which have occurred. This is critical for the DPP which is based on historical metrics, as opposed to the CPP which is based on expected future performance.
 - The uncertainty as to the Commission's likely response to a CPP proposal must be significantly reduced. In particular the proposal that the Commission may determine an alternative CPP is of considerable concern. We address this further in Section G. of our submission.
 - The complexity in the CPP proposal process which, in our view, makes this a highly unattractive option for a supplier of our size (ie: with approximately 10,000 consumers). It is difficult to see how a process, which we estimate may involve total costs (including supplier, external expert, verification, audit and Commission costs) of up to, and possibly exceeding, \$1 million, can be

deemed to be in the long term interests of these consumers, particularly where the outcomes are uncertain. The only other choice our business has is to reduce investment to comply with the DPP, which we believe is contrary to the Purpose Statement. We address these concerns further throughout the remainder of this submission.

A. Cost Allocation

12. GasNet reiterates its view that there are strong reasons why the Commission should exercise caution when considering whether, and how, common costs and assets should be allocated between regulated and unregulated businesses. Subpart (c) of the Purpose Statement set out in section 52A of the Act makes specific reference to efficiency gains achieved in the supply of regulated services. In addition, the section 52T requirements to determine IMs included in subclause 52T (3) a provision that IMs must not unduly deter investment by a supplier of regulated services in unregulated services. In our view a Stand Alone Cost (SAC) approach best meets this objective.
13. Notwithstanding the previous paragraph we have reviewed the Commission's proposed approach to a Fully Distributed Cost (FDC) model. In respect of the implementation of a FDC model, GasNet endorses the principles underpinning the proposed Cost Allocation Materiality Screening Criteria (CAMSC) which attempt to minimise the compliance costs and allocation processes where common or shared costs and assets are immaterial, or where they may result in a material impact on the performance of unregulated businesses. We address each of the proposed components of the cost allocation IM in the following paragraphs.
14. In addition GasNet supports the proposed approach which avoids a high level of prescription and allows businesses to use their own cost categories and their own allocators based on causal factors to implement the cost allocation IM. This approach in particular will assist GasNet manage its compliance costs for this aspect of the regulatory regime.

Components of the Methodology

Treatment of costs not directly attributable under accounting-based allocation approach

15. GasNet agrees with the Commission's proposed approach to cost allocation whereby GPBs are able to adopt allocators for not directly attributable costs and assets that are relevant to that firm's specific business. GasNet supports the use of causal relationships where available, and the use of proxy allocators, in the absence of causal-based allocators. However we would like clarification included in the Commission's final decision that the regulated businesses own cost allocations which comply with the IM and are presented as part of information disclosure will be used to set prices under both the default price path (DPP) and a customised price path (CPP).
16. In this respect we note that paragraph 3.3.64 of the Draft Reasons Paper indicates that the Commission may wish to adjust the businesses own allocations in order to "make comparisons more meaningful." We are concerned at the inference in this paragraph and submit that the businesses own allocations, consistent with the IM should be used for all regulatory monitoring and analysis and in particular revenue or price setting.

Cost Allocation Materiality Screening Criteria (CAMSC) process

17. GasNet endorses the Commission's proposed CAMSC principles. However as a small GPB we have concerns that the materiality thresholds are too low to capture instances where unregulated revenues are immaterial. For this reason, we suggest the threshold for the revenue materiality screening test be raised to 10% which is consistent with auditors' materiality thresholds.
18. We believe the revenue and operating expenditure (opex) screening tests are easy to apply and therefore meet the cost effectiveness principle. We also support the exclusion of opex arising from arms length transactions, from the opex screening test.
19. We also believe that the CAMSC would be improved with the inclusion of a gross profit screening test (ie: profit prior to the allocation of not directly attributable

costs). This would assist to counter the issue with wholesale versus retail businesses and those with relatively high and low gross margins, which render the revenue tests meaningless in some circumstances. It would also assist in meeting the not unduly deter investment in non regulated businesses objective by assessing the capability of non regulated businesses to share in common costs or assets. We believe this threshold should also be set to 10%, as for the revenue threshold.

20. We do note however that there appear to be inconsistencies in the application of the proposed screening tests for Opex and assets. In particular we note that Figure 3.2 and the associated explanation in Section 3.4; and Figure B1 and the associated explanations in Section B1 and B2; appear to use different definitions of total revenue/Opex/assets for the purpose of the denominators to be used in the screening tests. In some instances it appears as if the denominators are the relevant values attributable to the regulated service and in others the total business inclusive of regulated and unregulated services. In other instances the explanations are ambiguous. In principle, we believe the screening tests should be applied on the basis of the element to be tested as a proportion of the regulated business revenue/Opex/assets, such that:

- Unregulated revenues are at least 10% of regulated revenues
- Unregulated gross profits are at least 10% of regulated gross profit¹
- OCnDA² are at least 15% of regulated business operating costs
- AVnDA³ are at least 10% of regulated business fixed asset values.

21. We support the optional variation component of CAMSC also, which allows business specific circumstances to be incorporated into CAMSC and in principle allows for consideration of potential negative impacts on non regulated businesses. We support the proposed directors' certification component of the proposed approach along with the additional information requirements for the Commission. This information is likely to be commercially sensitive and should not be made publicly available.

22. Thus our proposed amendments to the CAMSC are:

- To increase the revenue screening threshold to 10%; and

¹ Where gross profit is measured prior to the allocation of operating costs not directly attributable

² Operating Costs not Directly Attributable

³ Asset Values not Directly Attributable

- To include a forth screen to test the materiality of the gross profits of unregulated businesses, which should also be set to 10%.

Use of ACAM as part of the Commission's cost allocation IM

23. GasNet endorses the Commission's proposed use of ACAM where applicable in the cost allocation process, ie: where not directly attributable costs and assets are deemed to be immaterial following the application of CAMSC. GasNet agrees with the Commission's draft decision that the rules for the current implementation of ACAM – as set out in the electricity information disclosure requirements – should apply in such situations. These are simple rules which we understand have been adequately tested over a number of years by many businesses.

24. We have not considered the proposed guidance on the allocation of boundary items for GPBs, but we understand this will be consulted upon during the consultations on information disclosure requirements for GPBs. Should this not be the case, and should the Commission propose including such guidance in the IM determination, we request an opportunity to review and comment on it before the IM determinations are finalised.

Calculation of cost allocation adjustment for the purposes of rolling forward the RAB

25. GasNet concurs with the Commission's proposed methodology for the calculation of a cost allocation adjustment for the purposes of rolling forward the regulatory asset base (RAB). That is the RAB must reflect the allocation of not directly attributable asset values, and thus it must be consistent with the methodology proposed each year. It is reasonable to implement the change in the opening RAB for annual disclosure purposes. We believe this adjustment is likely to be immaterial for our business.

Implementation of the Methodology

Information Disclosure

26. GasNet is broadly supportive of the Commission's approach to implementing the cost allocation IM when submitting information under annual information

disclosure requirements. We agree with the approach which allows each regulated business to define its own application of the methodology, and disclose explanatory information for interested parties.

27. We do not support the proposal for businesses to provide additional information to the Commission in order for the Commission to fulfil its monitoring role. This appears to add unnecessary compliance cost. GPBs will have applied the cost allocation IM in the audited disclosures, created an additional disclosure outlining the methodology, allocators, justifications, application of CAMSC and the outcomes and made this publicly available. This should be sufficient with the exception of the additional explanatory information to be provided to the Commission to support the optional variation under CAMSC. In our view the proposal duplicates the audit function and therefore imposes unnecessary cost.

28. We also note that for GasNet it is likely that the requirement to disclose the impact of the allocation methodology on our unregulated businesses will expose commercially sensitive information about our unregulated business to our competitors. This will occur due to the narrow scope of unregulated business operations we currently offer. Accordingly we believe that any public disclosure of the application of the cost allocation methodology should be limited to a:

- Description of the method;
- The categories of OCnDA and AVnDA and the relevant allocators applied; and
- The impact on the regulated services of applying the methodology as disclosed.

29. This would be consistent with the object of not unduly deterring investment in non regulated services.

Default Price-Quality Regulation

30. GasNet agrees that the cost allocation IM should only apply to DPPs indirectly via information disclosed as part of information disclosure requirements. Accordingly we would expect the information disclosure dataset to be used, in the first instance, in determining the DPP. There is no justification for alternative cost allocation outcomes from those included in information disclosure.

Customised Price-Quality Regulation

31. GasNet supports the draft decision that CPP proposals must comply with the cost allocation IM. Once again, these should reflect the application of the IM proposed by the regulated business (consistent with the information disclosure requirements). The difference from a CPP perspective is the requirement to forecast the allocations of not directly attributable costs and assets and accommodate potential changes in the circumstances facing regulated and unregulated businesses accordingly.

B. Asset Valuation

32. GasNet agrees that the initial RAB for GasNet should be established using the financial year-end regulatory asset values disclosed at 30 June 2009 in accordance with the Gas (Information Disclosure) Regulations 1997, with appropriate adjustments to ensure it is fit for purpose.

33. An opening RAB based on the existing disclosure value is consistent with our shareholders expectations. It will also assist us minimise our compliance costs associated with establishing the opening RAB subject to the limited adjustments described below.

34. In principle we support the proposed roll forward methodology, although we reiterate our earlier concerns regarding the impact of the indexation component of the roll forward methodology on cash flows.⁴ We acknowledge some of these concerns have been addressed elsewhere in the IMs – however at this stage there appears to be no explicit intention to include cash flow considerations when setting controlled prices under either a DPP or a CPP. We acknowledge the development of the DPP for GPBs is not well advanced at this time. We address this point further in response to the CPP IM, and encourage the Commission to also consider it further when developing its proposed approach to the DPP and information disclosures.

⁴ Refer GasNet, *Submission on Input Methodologies Discussion Paper*, 7 August 2009, page 24

Components of the Methodology

Adjustments to the 2009 Disclosed Values

35. For the purpose of this submission we have not considered the asset valuation IM as it applies to the controlled gas distribution businesses of Vector or Powerco. Our comments are made in relation to GasNet's distribution business which is not currently subject to control.
36. GasNet agrees with the Commission's proposal to use the disclosed replacement cost valuation for GasNet at 30 June 2009 subject to limited adjustments. This valuation reflects the most recent Depreciated Replacement Cost (DRC)⁵ valuation established in 2008, rolled forward to 2009 with adjustments for additions (at cost) and depreciation.
37. We support the proposal to allow corrections to be included in the opening RAB, to reflect information now known, which had it been known at the time the valuation was originally prepared (in 2008 in GasNet's case) would have been included in the valuation. GasNet has recently undertaken a review of its asset information and associated GIS systems and identified data improvements which need to be incorporated into the valuation. These include the following:
- The inclusion of network valve assets previously omitted from the valuation;
 - The inclusion of discovered pipelines previously omitted from the valuation;
 - The inclusion of mini district regulating station assets previously omitted from the valuation;
 - Corrections to pipeline lengths and commissioning dates for assets which are included in the valuation; and
 - The inclusion of rail, road and river crossings previously omitted from the valuation.
38. There may also be other adjustments consistent with the categories set out in paragraph 4.4.38 of the Draft Reasons Paper which GasNet may identify when preparing its opening RAB.

⁵ This includes optimisation adjustments for obsolete assets and assets surplus to requirements.

39. In addition, as proposed in the draft IM, assets which are used to supply services other than gas pipeline services as defined in section 55A of the Act must be omitted from the valuation. Currently our disclosed value includes GMS assets which will need to be excluded. In addition, there may be further adjustments required following the application of the cost allocation IM.

Works under construction

40. GasNet is supportive of an approach which aligns with financial reporting standards. Accordingly the NZ IAS 23 *Borrowing Costs* requirement to capitalise financing costs during the construction of an asset will influence the cost of the asset to be included in the RAB roll forward. This will apply to the RAB from the date of commissioning and therefore no works under construction are to be included in the RAB. The borrowing cost allowance provides an appropriate solution to our originally proposed alternative to include works under construction in the RAB.

41. We support the restriction on the rate to be applied to be no more than the Weighted Average Cost of Capital (WACC) which is a pragmatic solution consistent with the Commission's expectations of only prudent asset costs entering the asset base.

Intangible assets

42. GasNet broadly agrees with the Commission's draft decision on intangible assets, which is to be consistent with NZ IAS 38 Intangible Assets with the proviso that any goodwill is to be excluded from the RAB.

43. The Commission has suggested NZ IAS 38 means working capital is excluded from RAB. This interpretation is inconsistent with Generally Accepted Accounting Practice (GAAP) which include for financial reporting purposes both fixed and current assets and liabilities including the various components of working capital. The reasons for excluding working capital from the RAB as set out in the Draft Reasons Paper are:

- It would add complexity to the task of interested parties in monitoring and analysing financial disclosures;
- Implementing rules for working capital would add little value; and

- Working capital is not likely to have a material impact on RAB.⁶

44. We do not agree that the reasons set out above justify the exclusion of working capital from the RAB, given this is necessary to the operation of a business. The complexity in monitoring and analysing financial statements is contrary to the complexity the Commission is currently proposing for other IMs, such as cost allocation, and also contrary to the third point that working capital is not material. Working capital may or may not be material, in the same way non system fixed assets or borrowing costs during construction may or may not be material however they are assets that are required to provide gas pipeline services, and therefore should be included. In addition, these items are already measured for financial reporting purposes and can be included in the RAB accordingly (without the Commission developing specific “rules” for them) in the same manner as non system fixed assets are to be included.

45. In addition, to be consistent with NZ IAS 17 leases are to be included in the RAB. These do not currently impact on GasNet but in principle we support a definition of RAB which is consistent with the financial reporting standards.

Treatment of additions and disposals

46. GasNet agrees that additions and disposals of assets in the RAB require an annual adjustment, however additions should be included as at the date they are commissioned (for the purpose of depreciation and future disposal), and disposals should be made at the carrying value in the RAB from the date of decommissioning or disposal. This is consistent with GAAP. In the context of GPBs, an asset is commissioned when it is deemed to be “in service”, for example when a new subdivision is developed, the reticulation to and around the subdivision may be in service, but may initially only supply a small subset of the consumers eventually connected to the network.

47. This approach however ignores the requirement of GPBs to hold strategic spares in order to be able to provide gas pipeline services, that is maintain supply consistent with consumer demand. Accordingly strategic spares should be included in the RAB. They are in the opening RAB, and additions and or

⁶ Commerce Commission, *Draft Reasons Paper*, paragraph 4.4.72.

disposals which impact on the spares balance should be included in the annual adjustments to RAB.

Treatment of asset transfers

48. GasNet agrees that asset transfers between a GPB and other entities that are not regulated under Part 4, related parties, and other related suppliers, should be treated consistent with GAAP.

Lost and found assets

49. GasNet believes the Commission's proposed treatment of lost and found assets is reasonable. In particular we support the intention for such adjustments to be excluded from the revaluation component to be recognised as revenue.

Vested assets

50. GasNet supports the Commission's draft decisions that new vested assets should enter the RAB at cost, that is the price paid for those assets, which is consistent with GAAP.

Easements

51. GasNet agrees with the Commission's draft view that new easements should be included in the RAB at cost in the year in which they are acquired, consistent with the price paid for those easements (where those costs are capitalised). We also agree that where an easement is granted for a limited life, it should be depreciated consistent with that life.

Cost allocation adjustment

52. GasNet agrees that the roll forward formula should include an annual adjustment to reflect any changes in the allocation of not directly attributable asset values to the gas pipeline services of a GPB.

Asset lives

53. Asset lives are to be applied in calculating straight line depreciation for each asset component. The asset lives set out in Table 4.1 of the Draft Reasons Paper are reasonable with the exception of the 7 year life assigned to telecommunications systems. GasNet submits that telemetry assets should have a 10 year standard life. We also note that the table does not include asset lives for non-system fixed assets and submit that these should be determined in accordance with GAAP which is cost effective.
54. We also note that the draft decision for depreciation on spares is that they are depreciated from the date they are delivered to store. This is not appropriate and inconsistent with GAAP. Spares should be depreciated from the time their remaining service potential reduces, which for most assets is not until they are put in service. It is inaccurate to depreciate them any earlier, adds complexity to the accounting for them, and has the impact of artificially reducing their useful life.
55. GasNet supports:
- The use of similar (and not greater) asset lives for assets not covered by the standard table (as set out in Table 4.1 in the Draft Reasons Paper);
 - The application of contract lives to dedicated assets to ensure the profile of the asset related costs are consistent with the revenue able to be recovered from those assets;
 - The adoption of reduced asset lives for selected assets on the basis of performance or environmental conditions; and
 - The extension of remaining lives following refurbishment, subject to independent engineering review and a cap on the life extension equivalent to the standard total life for that asset.
56. The Draft Reasons Paper (paragraph 4.4.16) indicates that the dedicated asset life option must be applied at the beginning of a contract. This means that dedicated assets which are in the opening RAB, for which a contract already exists, are excluded from this provision. In our view there is no justification for this restriction and dedicated assets in the opening RAB should be able to be depreciated over the remaining life of the contract. This will ensure the profile of

the asset related costs will match the revenue profile of the contract (and the gas pipeline services) to be provided.

Non-standard depreciation

57. The draft decision is that additional non standard depreciation approaches will only be permitted under a CPP. GasNet supports in principle the intention of alternative depreciation as one mechanism to assist address potential:

- cash flow constraints;
- industry wide risk;
- stranded assets; and
- changes in the profile of demand for an asset over time.

58. GasNet does not support the proposed restriction of the alternative depreciation option to CPPs. GasNet believes that the intention of the Act was that the DPP would apply to most regulated suppliers most of the time. The CPP option provides an alternative for suppliers with specific circumstances, of a material nature, which are unable to be accommodated in the DPP. In addition, as the DPP is expected to primarily rely on information disclosure data (and thus the components of the IMs which are relevant for information disclosure) we believe that the alternative depreciation option should be included in the asset valuation IM to apply to all regulatory mechanisms applying to GPBs. This could be accommodated using the same independent verification process and information disclosure requirements as proposed for the refurbishment adjustment to remaining lives (as set out in the final two points of paragraph 4.4.126 of the Draft Reasons Paper).

59. By providing for alternative depreciation in information disclosures, subject to appropriate independent sign off, this approach is able to be incorporated into the DPP in a cost effective manner, thus contributing towards the cash flow considerations noted above.

Stranded assets

60. Consistent with our comments on alternative depreciation allowances, we support the proposal for stranded assets to be retained and depreciated in the RAB over

the remaining life of the asset to ensure full cost recovery under a DPP. This would apply in information disclosure and DPPs (and CPPs unless an alternative was proposed by the supplier).

Fully depreciated assets

61. GasNet agrees with the Commission's proposed approach to fully depreciated assets in principle, by applying a minimum remaining life for assets in use at the beginning of the period, of five years for a CPP, coinciding with the regulatory period.

Implementation of the Methodology

Information Disclosure

62. We anticipate contributing to the more specific consultation on information disclosure requirements once that consultation process is more advanced. As previously indicated, the existing information disclosure regulations for GPBs are long overdue for review. In summary however, in respect of the draft determinations we submit that the proposed asset valuation IM as it applies to information disclosure is amended in the following ways:

- The inclusion of working capital;
- The inclusion of annual adjustments for stores and spares (which should not be dependent on the commissioning date criteria applied to other assets);
- An amendment to the standard life table for telemetry assets;
- Depreciation of non-system fixed assets in accordance with GAAP;
- Provision for dedicated assets to be depreciated over the remaining contract life, where these assets exist within the opening RAB, and where a contract already exists; and
- The inclusion of the options for alternative depreciation allowances supported by independent review (without the materiality limits set out in the first and second points of paragraph 4.4.13 of the Draft Reasons Paper – refer below).

Default Price-Quality Regulation

63. The amendments noted above will work their way into the DPP assuming the information disclosure data is used for the purpose of setting the price component of the DPP. Thus the amendments suggested above are critical in our view, particularly in light of paragraph 4.5.8 of the Draft Reasons Paper. This sets out how the Return on Investment (ROI) indicator (of which asset valuation is a major component) to be generated as part of the information disclosure regime, will be used to inform the price component of the DPP.

Customised Price-Quality Regulation

64. As previously indicated GasNet's primary objective is to ensure information disclosure and DPP regulation accommodates our needs, as we anticipate the CPP process will be prohibitive from a cost and resource point of view. We have briefly considered the proposed materiality thresholds to apply to the alternative depreciation allowances as set out in paragraph 4.4.143 of the Draft Reasons Paper.

65. Our initial response is that other than the requirement for the total depreciation charge over an asset's life is not to exceed its total value, we do not support the additional limitations (namely non standard depreciation for an asset should fall between +/- 20% to 50% of straight line depreciation and the aggregate depreciation should be no more than +/- 5% depreciation over the term of the CPP). The CPP is intended to reflect business specific circumstances. These limitations are arbitrary and inconsistent with this objective. Accordingly, assuming the alternative depreciation proposal has been verified by an independent expert it should be permitted, irrespective of its materiality.

C. Treatment of Taxation

66. GasNet supports the Commission's draft decision that tax obligations must be estimated using a 'deferred tax' approach, in particular:

- ensuring net present value (NPV) equivalence with a tax payable approach by amortising revaluations, and by amortising the difference between the initial RAB and the initial regulatory tax asset value, over the lifetime of the assets;
- setting the opening deferred tax balance to zero; and

- setting the opening tax value as the lower of opening tax written down value and RAB.

67. A deferred tax approach is consistent with the way most other items in the regulatory revenue statement are treated and assists to smooth the regulatory tax allowance across the life of the asset. It is also consistent with existing financial statements, and thus is most readily understood by consumers and shareholders.

D. Cost of Capital

68. GasNet has not engaged a cost of capital expert for the purposes of responding to the draft determinations and therefore have not submitted in detail on each of the cost of capital parameters, the use of the Capital Asset Pricing Model and other related issues.

69. However we are concerned that the draft determination includes in it decisions regarding the individual parameters which are significantly different to those adopted for the gas authorisation, and which result in a cost of capital estimate which is substantially below that used in the authorisation. In the table below we summarise the two regulatory decisions.

WACC Calculation	Gas Authorisation (as at 24/08/2005)	Input Methodologies (as at 09/08/2010)
Risk-free rate	5.88%	5.00%
Debt premium	2.70%	2.00%
Leverage	40%	40%
Asset beta	0.53	0.44
Debt beta	0.00	0.00
TAMRP	7.0%	7.1%
Corporate tax rate	30%	28%
Investor tax rate	30%	28%
Equity beta	0.88	0.73
Cost of equity	10.30%	8.81%
Cost of debt	8.58%	7.00%
Debt issuance cost	0.0%	0.3%
WACC	8.58%	7.60%
WACC (75th percentile adjustment)	9.58%	8.60%

70. The cost of capital benchmark is to be used to set prices for the DPP, and for CPPs, it is an important input into the controlled prices for GasNet. It has the same role therefore as it did in the Gas Authorisation. Other than differences to reflect changes in tax rates and debt costs which have occurred since the Gas Authorisation we cannot rationalise how the remaining assumptions can have been changed to reduce the cost of capital estimate so significantly.

71. In addition we note that the resulting cost of capital estimate falls below the expected benchmark of our owners, who are required to weigh up the opportunity cost of investing in the gas pipeline business versus other businesses.

E. Pricing Methodologies

72. GasNet supports the draft decision to include in the pricing methodology IM pricing principles based on efficient pricing. This approach is consistent with an intermediate level of regulatory intervention on regulated suppliers pricing approaches, and therefore provides suppliers with the necessary flexibility to manage the needs of consumers and regulated services over time.

Components of the Methodology

Pricing Principles

73. GasNet supports the pricing principles included in the draft determination. In particular we support the amendments to the principles which were adopted for the Gas Authorisation in order to:

- Recognise potential legislative or regulatory constraints on pricing;
- Reflect the importance of pricing methodologies for consumers (rather than customers);
- Recognise non standard arrangements to meet consumer demands; and
- Provide transparency.

Implementation of the Methodology

Information Disclosure

74. We support the proposals for the pricing methodology IM to apply in information disclosure regulation on the basis that the GPB is required to disclose the methodologies actually applied and the extent to which they meet the principles. This does not require compulsory application of the principles.

75. We anticipate contributing to the forthcoming consultation on pricing methodologies in the context of information disclosure in due course.

Default Price-Quality Regulation

76. We support the draft decision that pricing methodologies will not apply under the DPP for the reason that the costs of achieving this are likely to be considerable, without a readily quantifiable benefit.

Customised Price-Quality Regulation

77. We refer to the proposals for pricing methodologies under CPPs in Section G. of this submission.

F. Rules and Processes

Components and Implementation of the Methodology

Specification of Prices

78. GasNet supports the specification of prices using a weighted average price cap, for the reasons outlined in our 14 May 2010 submission on the DPP Issues Paper. We understand the Commission is to undertake further consultation on this matter in due course.

Pass Through Costs

79. We support the proposal to include industry levies and local authority rates as pass through costs. We are not certain however that the criteria set out in paragraph 8.4.3 of the Draft Reasons Paper for defining a pass through cost is appropriate. In particular it is not clear why there is a requirement for forecasting accuracy in the criteria. The more important criterion is the first one, ie: that regulated suppliers are not able to control or influence the costs and therefore should not be accountable for changes in them when prices are set using a DPP or CPP framework (and thus any changes in uncontrollable costs cannot be reflected in prices). Accordingly we do not support the second criterion.
80. We do not agree with the decision to exclude from the definition of pass through costs any new regulatory or legislative costs imposed on regulated suppliers. Under a DPP, suppliers are unable to recover new costs, and the proposed circumstances for allowing the DPP to reopen are not adequate for these purposes. If the proposed IM was applied, and a new legislative requirement was imposed on GasNet, it would have no choice but absorb the associated costs. The CPP option is not a realistic option for us (refer section G.) and nor should it be to simply address new legislative requirements (which are most likely to apply to the entire sector).
81. We acknowledge the Commission's consideration of other "recoverable costs" including CPP costs and incremental rolling incentive scheme (IRIS) costs. We are concerned at the risk this mechanism introduces as it seems to provide the Commission with a large degree of discretion as to what proportion of these costs are able to be recovered, and it is not clear how this would be managed. In our view the full costs of a successful CPP proposal should be recoverable as pass through costs, on the basis that it would have been deemed to be in the long term interests of consumers. We have not considered IRIS in detail.

Reopeners

82. The draft determination proposes that a DPP may only be reopened if there is a material error discovered or false information has been provided. A broader range of reopeners is proposed for CPPs including catastrophic events and legislative or regulatory changes.

83. As we have stated on a number of occasions, our primary objective is to ensure the DPP can meet our needs as we believe a CPP option will not be in the best interests of our consumers. The costs associated with any CPP proposal GasNet would be required to prepare would add considerable cost to our business which would need to be shared across our 10,000 consumers.
84. Accordingly, the DPP must be able to accommodate external and unforeseen events which have a material impact on our business for which we have no control and no ability under this draft IM to recover the associated costs. Therefore the same proposals as the reopeners for a CPP (catastrophic events and legislative or regulatory changes) should apply under the DPP.
85. In addition we note that in respect of catastrophic events, by the time a CPP proposal is made and considered and new prices set, at least two years will have passed since the event. A CPP is designed to address future needs not past events. This is a cumbersome solution to this issue, which in our view can be readily resolved by allowing catastrophic events to be accommodated in the DPP as a reopener.
86. By way of example we refer to two past extraordinary events which resulted in sustained supply losses to consumers and unforeseen additional costs to our GPB.
- Water ingress into a network requiring it to be shut down and considerable effort expended to extract the water. Our last major event of this nature which occurred in 1994, affected approximately 300 consumers, and resulted in direct costs to us of \$100,000 (or \$145,000 in today's dollars). It was caused by a leak on a water pipe which penetrated an adjacent gas pipe. This is equivalent to 9% of our total opex for 2010.
 - Transmission system failure resulting in loss of supply to a network due to significant pressure reduction. In severe situations the distribution network must be shut down and in order to restore supply, the networks must be recommissioned and for safety reasons each consumer's installation must be visited in person to undertake a gas leak check and relight appliances. A recent event resulted in total loss to two networks and affected approximately 600 consumers, with a direct cost to us of \$22,000 or 1% of our 2010 opex. This incident was isolated to two of our smaller networks, however if a similar

incident had affected our largest network (Wanganui), the impact and associated costs would have been significantly greater.

87. We do not believe that the proposed CPP process is suitable for addressing such events, and it is unreasonable to require us to manage our performance within the DPP should such events occur which are material to our business and over which we have no control.

G. Customised Price Quality Paths

Components of the Methodology

88. We have not considered the CPP requirements in detail for the purpose of this submission. However we have set out below our initial observations and comments on the proposed process and information requirements.

Commission's Evaluation Criteria

89. We note that the proposed evaluation criteria set out in Subpart 2 of the CPP IM include an option for the Commission to consider the proposed CPP against alternative CPPs, which must be consistent with the IMs. This proposal concerns us and in our view introduces an unnecessary source of uncertainty for an entity considering a CPP proposal. We had understood that the intention of the Act was to allow for a relatively cost effective regulatory mechanism for GPBs (the DPP supported by information disclosure) and the option of a CPP to reflect business specific circumstances not able to be accommodated by the DPP. Accordingly we believe that the Commission should as its benchmark consider whether the CPP proposed by the regulated supplier better meets the Purpose Statement, in the context of the circumstances facing the GPB, relative to the DPP.

90. The proposed criterion 5.2.1 (b) appears to give the Commission a significant amount of discretion to make judgements about how businesses will meet their requirements with an obvious tension between short and medium term expenditures. In our view any alternative to the CPP proposed by the supplier should reflect only those amendments agreed with the supplier through the Commission's review process, with sufficient justification for the changes.

Cash flows

91. There appears to be little consideration of the cash flow implications of a CPP proposal. By adhering to a strict building block model for determining allowable revenue, there is no recognition of the funding constraints which may limit a regulated supplier's ability to meet its supply obligations in periods of high investment. Accordingly we submit that an additional evaluation criterion must be "the ability of the supplier to prudently fund its planned expenditures".

Capex, Opex, Demand and Network Information Requirements

92. We have also briefly considered the proposed information requirements for capex, opex, demand and network information for gas distribution businesses.

93. We note that Strata specifically use a different definition of Opex and Capex direct and indirect costs to that used by the Commission in determining directly attributable and non-directly attributable costs⁷. This will inevitably lead to unnecessary confusion in the implementation by individual businesses. In this context we also note that the Information Disclosure Requirements (IDRs) for GPB's are long overdue for review. The Capex and Opex templates appear to have been derived after some consideration of IDRs for electricity networks. We are concerned that while this may be a pragmatic approach for the electricity sector, there may be consequences for the IDR yet to be developed for GPB's which are inappropriate for that purpose. GasNet wishes to carefully consider information requirements for IDR separately to the proposals for CPP and will contribute any thoughts during the IDR consultation process.

94. GasNet also notes that a number of the points raised in the meeting between industry participants and the Commission on 20 May 2010 have not been taken into consideration in the current draft. Examples of such matters include:

- the financial year for gas businesses (discussed in further detail below);
- Capex categories;
- Opex categories; and
- asset grouping.

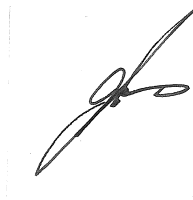
⁷ Strata Energy Consulting Limited, *Specifying the CPP information requirements relating to capital expenditure, operating and maintenance expenditure, and demand*, 30 June 2010.

95. Based on the definition of financial year provided in the 'qualitative' document, all 'quantitative' information to be provided in the template spreadsheets is required to be determined for a 1 April to 31 March financial year. It is noted that in the CPP Information Requirements document at paragraph 201, a more reasonable interpretation is suggested; however this is inconsistent with the draft determinations. As GasNet uses a 1 July to 30 June financial year, all data will necessitate recasting which is both costly to achieve and increases the allocation complexity as it becomes a multi-year issue. We therefore submit that the CPP data requirements must be specified consistent with the financial year commencing 1 July.

General

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, light-colored rectangular stamp or watermark.

Geoff Evans

General Manager