Vector Limited
101 Carlton Gore Road
PO Box 99882, Newmarket
Auckland, New Zealand
www.vector.co.nz

Corporate Telephone
+64-9-978 7788

Corporate Facsimile
+64-9-978 7799

Peter Davies
Gas Industry Company Limited
PO Box 10 646
Wellington 6143

5 February 2009

Dear Peter,

FY2010 LEVY FOR GAS INDUSTRY CO

1. On Gas Limited and Vector Gas Contracts Limited ("Vector") welcomes the opportunity to submit its views on the FY2010 Levy for the Gas Industry Company ("GIC"). Vector notes the importance of continuing to consult on levy proposals for the accountability and transparency of the GIC.

2. The first part of this submission provides specific comments on aspects of the levy Vector considers require more attention. These aspects include:

    - the increasing costs faced by the gas industry;
    - the GIC's Indicative Work Programme; and
    - Vector's views on the one-off levy for the development costs of the Downstream Reconciliation system.

3. Vector then provides comments to specific questions in Appendix A.

Increased Gas Industry Costs

4. Vector is aware the GIC has obligations under the Gas Policy Statement ("GPS") to achieve specific outcomes identified by the Minister.

5. However, Vector has concerns regarding the New Zealand gas market's ability to absorb the additional costs it will be incurring in the coming years.

6. The GIC alerted industry of the "temporary pressure" the GIC is facing which, in turn, is passed onto industry though levies and market fees. The GIC stated in the 07/08 Annual Report that:

> "there is expected to be some temporary pressure on operating budgets while the company transitions into this new level of activity[1]."

7. At the GIC Levy Workshop on 28 January 2009, The GIC gave a clearer picture of what "temporary" meant by noting that the costs the industry would be facing this year (imposed by new industry regulation) would not change for the next 5-6 years.

Ensuring that regulatory driven costs are proportionate to the New Zealand gas market

8. The above statements highlight the need for the GIC to maintain an overall view of the New Zealand market and ensure costs driven by regulations are exceeded by the benefits. As the GIC is of course aware, there is substantial pressure on businesses and domestic users arising from the current economic downturn and financial market turmoil. Imposing new costs on users needs to be considered carefully, and the assessment of the potential for competition benefits realistic, given inherent qualities of the sector, including the dominance at the production end of the market and the relative demand and supply balance at different points in time.

9. In Vector's view, it is important to recognise that gas remains a discretionary fuel and the overall delivered costs, including those driven directly and indirectly by regulation, need to be competitive relative to other fuels.

10. Given the thinness of the market, Vector considers the GIC needs to be proactive in separating the "nice to have" changes from the ones that are crucial, enabling the market to operate more efficiently. Only changes that demonstrate an overall net public benefit should be progressed.

11. Once a change is identified as necessary and progresses as a work stream, it will be important that the GIC carefully manage the projects and avoid any increases in costs, which do not produce a justifiable or quantifiable consumer benefit. Vector reiterates its comments from prior levy consultation that there is an, "increasing expectation for GIC to demonstrate how its work streams are delivering best value for consumers.[2]" Additionally, the submission requested that the GIC "more explicitly consider the financial impact on consumers, assessed against the benefits they receive.[3]"

12. Vector notes the delay in the Switching and Registry work stream and the GIC's view on that delay, "ultimately, the delay means that the GIC will better know exactly what it will get and at what cost, then if it has proceeded to a

---

[1] Gas Industry Company, *2007/2008 Annual Report*, pg.6.

[2] Vector Limited, *Submission on Levy for Gas Industry Co for the Year 2008/2009 Financial Year*, pg.2.

[3] Vector Limited, *Submission on Levy for Gas Industry Co for the Year 2008/2009 Financial Year*, pg.2.

final agreement.[4]" Vector commends this view, as it shows flexibility when delivering specific GPS driven outcomes. Vector encourages the GIC to continue to adopt this approach when progressing future work streams.

13. Given the current economic climate, there is an ever present need for the GIC to be aware and responsive to the impact of the detail of proposed rules and regulations (including development costs) and relay those costs to industry.

Indicative Work Programme

14. Vector was disappointed to see that the GIC did not consult Stakeholders in developing its Strategic Plan for 2009-2011. The model that has been adopted is a "co-regulatory model" resourced by industry funding and Vector suggests that consultation should take place to help gain a sense of what industry participants, the funders, consider priority work streams.

15. Additionally, Vector sees value in the GIC issuing upcoming work plans once a month for a rolling 12-month period. Doing so would assist the GIC with managing external capacity constraints by allowing companies to plan ahead, limiting "bottle necks" that have occurred with key resources in the past year.

16. Vector highlights two areas where sound judgement will need to be used when assessing what work the GIC will endeavour to take on, ensuring it has explored all options and consulted thoroughly. The two areas are discussed below.

Measuring Competition

17. Under "Market Development," in section 2, page 5 of the FY2010 Levy paper, the GIC outlined one of its' desired outcome to minimise barriers to retail and wholesale competition. Vector shares the view that increasing competitiveness of the retail and wholesale gas businesses is desirable; however, in Vector's view the increase in competition experienced downstream in recent times has been due to the increased supply from alternate fields and the market adjusting to a shift in the relative supply-demand balance.

18. Before any work is pursued in this area, Vector submits that there needs to be a comprehensive and realistic assessment of what competition really means in the gas market and what an effective level of competition would look like. It may simply be a reality that given the nature of the risks and size of the market that the level of potential competition that is achievable in the market sits closer on the spectrum to oligopoly than the perfect competition standard. From Vector's view point, it is important to be realistic about this and acknowledge this at the start, rather than develop costly

[4] Gas Industry Company, *2007/2008 Annual Report*, pg. 14.

market arrangements in the pursuit of a vision of competition that is unobtainable due to fundamental industry characteristics.

19. Further, Vector considers that the Commerce Commission would be the body best resourced to identify areas in the New Zealand gas market suffering from lack of competition and the extent of the problem, if applicable. For example, the Commerce Commission has recently considered the state of competition in the gas market and how competition is affected by long term contracting in its investigation into Todd's claims that the Maui ROFR contracts were uncompetitive[5].

20. In addition to the above, it is unclear what role GIC has in tracking or stimulating downward pressure on prices, as this too would seem to fall under the ambit of the Commerce Commission.

Improving Consumer Outcomes

21. The last desired outcome under "Market Development" is to improve consumer outcomes. Vector recognises that this in an important goal for the GIC to have and one in which it can directly influence, however, Vector reminds the GIC that process requires the GIC to identify all reasonably practical options prior to undertaking any actions.

22. For instance, the GIC should explore what has already been done in the industry to improve consumer outcomes, such as enhancing information available to consumers on the benefits of gas.

23. The Gas Association of New Zealand ("GANZ") has completed a considerable amount of work on providing consumer information. Vector encourages the GIC to engage with GANZ before embarking on its own Direct Use of Gas ("DUOG") work stream.

24. Retail contracts is another area where the GIC should consider all possible alternatives. Vector would prefer that the terms in the Electricity and Gas Complaints Commission ("EGCC") Code are utilised but is also aware that this is dependant on the Preferred Consumer Complaints Scheme being determined. The work GANZ has done on disconnection and reconnection protocols will also need to be examined in relation to this work stream.

Vector's Views on the One-Off Levy

25. The remainder of this cover letter addresses the GIC's proposal to impose the unbudgeted development cost of $1,052,500 attributable to the implementation of the Gas (Downstream Reconciliation) Rules 2008.

---

[5] See Commerce Commission Draft Determination: Todd Petroleum Mining Company Limited and Todd Taranaki Limited, 14 April 2008.

26. Given that the entire cost is to be levied in a single year, which is inequitable from the point of view that future generations of consumers will also benefit from the reconciliation arrangements, it is critical that an equitable cost allocation approach is determined.

27. Vector does not support the methodology behind the cost allocation of the GIC's proposed one-off levy for the 2010 financial year. While Vector acknowledges that the one-off development cost of the Gas (Downstream Reconciliation) Rules 2008 will need to be recovered, it does not believe the forces driving the fee reflect true causer pays principles, more specifically, the cost does not fall on the mass market or, non-time of use ("non-TOU") ICPs, which drive the work-load of the reconciliation agent and who are principally responsible for UFG due to the relatively imprecise data on usage from such consumers.

Fee Setting Principles

28. Vector agrees that the GIC's six principles are appropriate to use when the company is designing the industry levy. However, Vector considers that the allocation of the one-off fee does not comply with several of these principles.

29. Namely, the allocation of the one-off fee based on gas volume does not address principles 2, 3, and 5. Each principle is discussed in turn below.

Principle 2: Beneficiary/ Causer pays

30. Vector notes that the Gas (Downstream Reconciliation) Rules 2008 ("the Rules") were designed to establish more efficient and accurate means of allocating unaccounted for gas ("UFG") among retailers. Rather than address the root cause of large amounts of UFG, the Rules instead socialise the allocation of UFG and spread it around amongst retailers at the gas gate. There is little incentive on parties to improve the accuracy of their systems or make trade-offs between improved accuracy versus the costs of higher allocations of UFG.

31. Vector expressed its opposition to a volume-based allocation approach throughout numerous submissions. The underlying cause of UFG, and hence the need for a complex regime to allocate it, is at sites with an abundance of non-TOU ("mass-market") metering. The accuracy of time of use ("TOU") metering accounts for a minimal amount of the UFG that occurs. If UFG is discovered at a TOU site, the amount is easily detected and quantifiable. Under the new downstream allocation regime, UFG is spread amongst retailers at gas gates regardless of what type of meters they own. In effect, retailers with TOU metering have to pay for UFG that would appropriately be attributable to the mass market.

32. Vector believes that the above approach is fundamentally flawed as the regime places no incentive on mass market retailers, the main causers of the

problem, to investigate and minimise large cases of UFG or to invest in TOU metering (if that is more cost effective), which would have significant improvements on UFG levels.

33. The formula used for the ongoing fees, in respect of the Rules, is in Vector's view, also flawed. Rather than allocate the ongoing fees on a "per ICP" basis, which, would reflect that the causer (mass-market) of UFG would be paying the majority of the ongoing fees, the formula allocates the costs on a gas volume basis. Thus, users with larger volume, which are typically commercial consumers with TOU metering, are required to pay whilst receiving no benefit from the regime.

34. The cost allocation methodology of the special one-off development fee for the Downstream Reconciliation project in the FY2010 levy is based on the same incorrect interpretation of principles used for the ongoing fee structure.

Principle 3: Rationality

35. As outlined above, Vector does not believe there is a "strong and logical link between the participants on whom the levy is imposed and the costs being recovered through that (one-off) levy[6]."

36. Vector again notes that the GIC's rationale for allocating the fee on a gas volume basis was due to the same formula being used to determine ongoing fees under the Rules. However, weak analysis was demonstrated by the GIC to support its decision to allocate ongoing fees by volume. This analysis is discussed below.

37. In its' first discussion paper on downstream reconciliation, the GIC identified its preferred approach to funding arrangements as being:

> "tailor-made, so that the industry participants that obtain the most benefit from the accurate and efficient downstream reconciliation bear the cost of the arrangements[7]."

38. Later in the same discussion paper, the GIC goes on to note that:

> "Retailers will obtain the most benefit from the proposed improvements to reconciliation and, accordingly, should fund the cost. Allocating costs between retailers should be on the basis of the number of ICPs rather than by gas load. This is because the main benefits (e.g. improving

---

[6] FY2010 Levy for Gas Industry Co, pg. 9.

[7] Gas Industry Company, *Discussion Paper: Reconciliation of Downstream Gas Quantities*, 11 January 2007, pg 71.

> information quality) are proportional to the number of customers rather than gas volumes[8]."

39. The GIC went on to note that the company would undertake a cost/ benefit analysis of the above preference to ensure the correct beneficiary is identified.

40. The first Statement of Proposal shows a radically different view taken by the GIC on appropriateness of allocating fees. To support the GIC's new favoured approach the statement contained an "Appendix on Cost Allocation."

41. The appendix outlined that submissions received were largely in favour of cost recovery on a per ICP basis, the only submitters to say otherwise were the two principle mass market retailers, Contact Energy Limited and Genesis Energy Limited, who argued in favour of gas volume. The then current allocation agent, Tom Tetenburg and Associates expressed support for funding based on an ICP basis[9].

42. The appendix on cost allocation also attempts to determine which arrangement would gain the most benefit when assessed against the GIC's core principles for cost recovery. The GIC identified that it is hard to decipher which cost recovery option would result in the most benefit for five out of the six principles. However, the principle, 'User/Causer Beneficiary Pays' is identified as best aligning with a volume based approach.

43. The paragraph below illustrates this assumption:

> "Gas retailers will seek a margin to compensate them for the costs and risks associated with gas supply. Typically these margins will be based on a percentage of the total cost of supply, with the actual percentage varying according to the level of competitive pressure. As a result, customers which spend a large amount on gas will benefit more from competition than smaller users."

44. Thus, the above justification allowed for the GIC to allocate ongoing fees and consequently, the one-off levy fee on a volume based approach given, "the competition benefits are *expected* to be strongly correlated to volumes" and far outweighing the benefits attributable to a more accurate allocation of UFG- a key purpose of the Rules.

45. Vector finds this rationale difficult to comprehend. The relationship between reconciliation and competition is difficult to draw. Indeed a retailer that

---

[8] Gas Industry Company, *Discussion Paper: Reconciliation of Downstream Gas Quantities*, 11 January 2007, pg 71.

[9] The GIC note in the First Recommendation to the Minister, that Tom Tetenburg later changed his view on this through, "information discussions".

invests in improving accuracy of metering information will not receive full recognition of the benefits of this action, because the allocation of fees is dependent on volume and not the contribution to the UFG problem.

46. Thus, Vector does not agree with the analysis and conclusion reached by the GIC, which has no substantive evidence to support the claims.

47. Vector notes that a better rationale to use would be based on where the allocation agent dedicates the most amount of time when determining allocations. Working through a though experiment is useful. If the number of ICPs at a gas gate were to double, the work involved in reconciliation would increase in some proportion, whereas if the volume were to double, for the same number of ICPs the work would stay the same.

Principle 5: Equity

48. Apart from the ongoing market fee for the Rules (and as a consequence, the one-off levy) all other retail levies are charged on a per ICP basis (i.e. Retail Levy, Switching establishment and ongoing market fees) not on volume.

49. Therefore, the GIC, in order to align with its' 5th cost setting principle, equity, should consistently allocate costs associated with retail work streams on a per ICP basis.

50. Vector's view is that unless the GIC can quantify which methodology provides the greatest net benefits with associated users of the regime, then based on equity, the GIC should consistently apply a per ICP basis to fund retailer regulations.

Vector's Recommendation

51. Vector considers that the ideal solution to improve upon the method used for allocating costs, would be that the one-off development cost incurred from the Downstream Reconciliation system still be recovered through the FY2010 Levy but that it is allocated amongst participants on a per ICP basis instead of the inequitable allocation on gas volumes.

52. However, Vector realizes that justifying the dramatic formula change to make the levy in line with other retail levies, would be difficult given the timeframe the GIC is under to have the levy approved.

53. Therefore, Vector recommends a compromise of a 50/50 split of the one-off levy, between gas volumes and ICPs.

54. To supplement our recommendation, Vector has attached an exemption application to this submission requesting that the formula in rule 16.3 for ongoing fees is also changed to a 50/50 split between gas volumes and ICPs.

55. Vector requests that this transitional exemption remains in place until the GIC can decide upon a fairer and more equitable allocation through sound economic analysis.

56. Vector believes that our recommended compromise should be adopted as it more accurately meets the objectives of the GIC's Fee Setting Principles.

Concluding Remarks

57. In summary, Vector highlights the need for the GIC to continually undertake robust cost benefit analysis when justifying changes it imposes on the industry.

58. There is a balance to be struck between delivering on key outcomes identified by the Minister, while keeping the levy low and working under other industry constraints, such as resourcing.

59. Vector requests that the GIC adopt Vector's recommendation to allocate the one-off cost incurred from the Downstream Reconciliation project on a 50/50 basis as it is unclear from past analysis which methodology is most equitable.

60. This compromise will ensure that all retailers of the reconciliation regime share some of the cost.

61. Thank you for considering this submission. If you have any queries, or require further information, please feel free to contact me.

Kind regards

Nathan Strong
Manager Regulatory Affairs

Appendix A Recommended Format for Submissions

To assist the Gas Industry Co in the orderly and efficient consideration of stakeholders' responses, a suggested format for submissions has been prepared. Respondents are also free to include other material in their responses.

Submission prepared by: Nathan Strong, Manager Regulatory Affairs

QUESTION	COMMENT
Q 1: Do you agree with the proposal not to alter the structure of the levy for the 2010 financial year?	Vector agrees with the GIC's proposal not to alter the structure of the levy for the 2010 financial year.
Q 2: Do you agree with the proposal to recover the establishment costs of the Gas (Downstream Reconciliation) Rules 2008 by way of a one-off Special Purpose Levy, calculated on the same basis used to allocate the ongoing operational costs?	No, Vector believes this fee should be allocated on a 50/50 basis until the GIC are able to identify the most equitable allocation for funding. Please refer to Vector's covering letter for more detail.
Q 3: Do you agree with the proposed policy for funding the establishment, implementation and ongoing administration costs of gas governance arrangements?	Yes, Vector agrees with the GIC's policy to adopt a standardised approach to cost recovery.

QUESTION	COMMENT
Q4: Do you consider there to be any other items in the external work programme which should be included in the Company's strategic priorities for FY2010?	Vector agrees that the external work programme seems reasonable. However, Vector questions why Upstream Reconciliation was not included as a Strategic Priority for FY2010 and considers that it should be added. Vector notes that the balancing work programme will undoubtedly overlap with other areas in the wholesale market and interconnection arrangements. This highlights the need for the GIC to have the ability to identify where work streams overlap and proactively suggest efficiencies to simplify the work involved and where possible, the cost. Vector is pleased to see the GIC have identified the need to develop the capability and systems to administer the new arrangements. Vector stresses the importance of continuing to develop robust processes for rule changes, exemptions and consultation. These processes need to be confirmed and clearly published on the GIC's website, allowing participants more certainty that consistency is being applied.
Q5: Do you have any comment on the levy funding requirement for FY2010?	Vector realises that it may be too early for the GIC to identify what specific funding will be used for, however, reminds the GIC of its need to relay specific costs to industry as soon as they become known. Given its past errors in cost forecasting, there will be an increased pressure placed on the GIC to "get it right." Vector suggests that it would be timely for the GIC to undertake a review or audit of the issues it faced with increased costs to implement the Switching and Reconciliation projects. A review as such would help restore industry confidence in the GIC that it has learned from past funding mistakes.
Q6: Do you have any comment on the proposed levy for FY2010?	Please refer to Vector's covering letter.