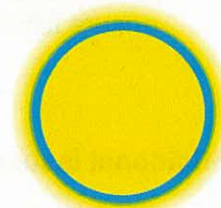


17 April 2009

Ian Dempster  
Gas Industry Company  
Level 8, The Todd Building  
95 Customhouse Quay  
Wellington

[Sent by email]

**POWERCO**



Dear Ian,

**Powerco's submission on *Application of Gas Governance Arrangements to Private Networks* discussion document**

1. This is Powerco's submission on the Gas Industry Company's ("GIC") consultation paper Application of Gas Governance Arrangements to Private Networks ("Private Networks Paper"), an independent review by Simon Terry Associates Ltd ("STA"). The GIC has stated that the aim of consultation is to seek feedback on how gas governance arrangements should be applied in the context of private networks, and to establish matters of principle which will assist the GIC in its review of existing and future gas governance arrangements. Powerco's comments focus on the rationale for regulation, the legislation and also references discussions at the GIC's 31 March 2009 workshop on the discussion document.
2. Powerco also directs the GIC to our submission of 10 March on Nova Gas Limited's ("Nova") Application for Exemption to Switching Rules. This submission covers Powerco's views on Nova's application for exemption from the gas switching registry in more detail.

**Overview**

3. The GIC asked STA to review the extent to which gas market governance arrangements ought to apply to "private gas distribution networks", including:
  - o Switching and Downstream Reconciliation Rules;
  - o the Gas Act 1992 and the Government Policy Statement of Gas Governance ("GPS"); and
  - o the regulatory provisions of the Gas Act 1992.
4. Neither the Gas Act 1992 nor the April 2008 GPS draws a distinction between "private" and "open-access" networks. Powerco believes that, as a starting proposition, a gas distributor's status as a private network should not of itself entitle it to exemption from any regulatory obligations.
5. On this basis, Powerco agrees with the conclusion of the discussion document that there is no general principle justifying the per se exemption of private networks from gas industry rules and regulations.

6. The previous exemptions of Nova from regulations administered by the Ministry of Economic Development (MED) and the Commerce Commission were before Powerco and Vector were placed under price control. As Geoff Bertram describes in his paper, previously regulation has aimed to encourage the growth of bypass networks and place competitive pressures on incumbent distributors (who were not under price control).
7. The situation has now changed. Open access gas distributors will be under price control from July 2010<sup>1</sup> mitigating the need for competitive pressure and positioning gas regulation with a wider role to play, eg improving the functioning of the gas market as a whole. The aims of this are clearly stated in the GPS. A private network, such as Nova, is a key part of a well functioning gas market, and on this basis must be included in market regulation to ensure fairness for end consumers and efficiency of the overall gas system.

### **Definitional issues**

8. An important starting point is the applicability of the Gas Act 1992 to “merchant pipelines”<sup>2</sup> such as Nova. The detailed regulatory provisions set out in the Gas (Downstream Reconciliation) Rules 2008 and the Gas (Switching Arrangements) Rules 2008 will apply to all “industry participants”, as defined in the Gas Act 1992. If a private network is not defined as an “industry participant”, a de facto exemption from regulations and rules is implied.
9. At the GIC’s 31 March 2009 workshop, Nova representatives questioned whether Nova met the definition of a “gas distributor” under the Gas Act, which relates to “any person who supplies line function services to any other person or persons”. Nova argued that it was supplying line function services to itself, rather than to end customers.
10. Nova also noted at the GIC’s workshop that their situation is similar to a closed network where a single feed enters a building complex and the end users are supplied off one ICP. Powerco believes that these are not private networks but small scale outlet pipe work, which the customer owns as it is downstream of the GMS (as outlined in the Gas Act 1992). This situation is very different to Nova operating a large network with a substantial number of ICPs.
11. Section 5 of the Act provides that the Minister may, by notice in the Gazette, declare a person to be a gas operator for the purposes of the Act if the Minister is satisfied that a declaration is necessary to enable the person to start or carry on a business as a gas distributor. The Gas Operator (Nova Gas Limited) Order 1998<sup>3</sup> declares Nova a gas operator, and therefore signals that the Minister intends Nova to be treated as a gas distributor under the Act.

### **Reasons for regulating the market**

12. A more fundamental issue in granting exemptions is the conceptual rationale for regulating private networks. A large part of STA’s discussion paper deals with characterising “private networks” and assessing the particular elements of private networks operating in bypass markets (the context in which applications for exemptions from industry rules have arisen in

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<sup>1</sup> Subject to exemptions provided in the Commerce Act 1986.

<sup>2</sup> Geoff Bertram refers to B Nitzov’s definition of a merchant distributor, where it “typically buys all the gas at the inlet point, transports it and resells it at outlets to different clients; it does not provide third party access, unless specifically required to do so by law”.

<sup>3</sup> 1988/46, 16 March 1998, Gazetted on 19 March 1998.

the past and can be anticipated under the new downstream reconciliation and switching rules).

13. The discussion document contains a complex examination of particular issues around access to essential facilities and "latecomer" bypass networks being entitled to private status with exemption from regulation.
14. Powerco believes that a useful starting point in considering whether it is appropriate to grant exemptions to particular distributors is to consider the reasons for the particular regulation in each case. There are likely to be two broad reasons for regulating:
  - a. as a response to market power or the absence of workable competition; and
  - b. to facilitate the market and/or build a market platform.
15. Under Part 4A of the Gas Act, the GIC's role relates to both spheres of regulation.
16. When considering whether an exemption from gas market governance arrangements should be granted to "private gas distribution networks", the case for an exemption is likely to differ depending on the underlying rationale for the regulation. Powerco submits that a case-by-case assessment be carried out to determine the reason for the particular regulation, and whether an exemption for a particular gas distributor is appropriate.

#### ***Response to market power***

17. The first rationale for regulating is the absence of workable competition or the presence of market power. In principle, if this is the justification for the particular regulation then an exemption is appropriate if it can be demonstrated that workable competition exists.
18. Examination of whether market power exists, or whether workable competition is absent from a market, raises the question of what amounts to workable competition. The discussion document refers to the Commerce Commission's previous considerations of gas distribution networks, in the context of the 2004 Gas Control Inquiry, and the authorisation for the supply of natural gas services by Powerco and Vector.
19. The Commission has clearly decided that workable competition exists in areas where a single bypass operator is competing with an incumbent. Powerco agrees with this position.

#### ***Nova exemption from Information Disclosure Regulations***

20. Information disclosure is a common regulatory tool to help limit market power. In section 6.1, the discussion document outlines Nova's exemption from the Gas (Information Disclosure) Regulations 1997, in respect of its landfill distribution networks. The paper also notes the MED informal extension in 1999 of Nova's exemption to include its bypass networks, on the basis that (with minor exceptions) Nova's pipelines did not have natural monopoly characteristics. The MED's amendment to the Information Disclosure Regulations was never Gazetted, but Nova has not been required to comply with the information disclosure obligations.
21. There is an argument that exemption from information disclosure regulations in bypass markets is appropriate. Information disclosure regulations are justified as a response to market power, and where workable competition exists an exemption is appropriate.

22. The key issue with the status quo is the lack of a principled consistency in the application of the regulation.
23. In areas where Nova's bypass networks exist, and which are therefore workably competitive, there is no principled reason why Powerco should remain subject to information disclosure requirements.
24. Powerco agrees that, in the decade since Nova's exemption was informally granted, the focus of the gas regulatory environment has shifted away from access to pipelines and the workability of competition, to issues such as reconciliations, unaccounted for gas and the ability of customers to switch suppliers. Continued or further exemption of private networks from regulation should be assessed in this context.

### **Facilitation of the market**

25. Powerco also notes that Nova's operational situation since the exemption from information disclosure regulation was granted has changed. For example, Powerco understands that landfill gas is no longer Nova's main source of gas supply and it operates mainly off the gas transmission system.
26. Further, the focus of the gas regulatory environment has shifted away from access to pipelines and the workability of competition, to issues such as reconciliations, unaccounted for gas and the ability of customers to switch suppliers. This is the second reason for regulating - solving market co-ordination issues to provide a better market platform. Continued or further exemption of private networks from this form of regulation should be assessed in this context. Any reference to the MED exemption should take this change of circumstances into account.
27. As the discussion document recognises (at page 49), the fact that a private network is bringing competitive pressure to bear on a small proportion of the market is not relevant if the question is whether one market participant should be exempted from regulations or rules directed at wider purposes than addressing market power (i.e. the functioning of the gas market as a whole).
28. In the context of regulations aimed at facilitating the gas market (or, more specifically, the gas distribution market), including the 2008 downstream reconciliation and switching rules, Powerco believes that the principled outcome should be a starting presumption of systematic regulation, or "everyone in". This is conventional in other industries. For example, all telecommunications operators are subject to the Number Administration Deed (an industry-based mechanism to centrally and independently administrate New Zealand's telecommunication numbering resources).
29. From this point, regard can be had to whether the particularities of individual gas distributors warrant exemption from specific regulatory obligations. Powerco believes this must be assessed on a case-by-case basis.

### **Test for considering whether exemption is appropriate**

30. The discussion document proposes (at page 23) that in assessing applications for exemption, a first step would be to identify the reasons for allowing the network to retain its private status in the first place.

31. The central test proposed is whether the exemption will strengthen or weaken the benefits which flow to gas users and/or the wider economy from the private status of the network, followed by a secondary test of whether an exemption would weaken or strengthen the credibility and effectiveness of the regulatory framework.
32. Powerco submits the logic is the reverse. If the question is exemption from a particular regulation, then the focus should be on the reason for regulating and not the abstract status of the applicant. The secondary test proposed by STA should in fact be part of the GIC's primary considerations.
33. After starting from a presumption that the (relevant) regulations should apply to all distributors, the GIC should consider whether there is justification for granting an exemption for a particular distributor. In asking this question, the GIC should ask whether the granting of an exemption from a specific regulatory obligation would weaken or strengthen the credibility and effectiveness of the regulation provided for under Part 4A of the Gas Act (including the 2008 GPS).
34. Where the regulation in question is related to the GIC's access objective, an assessment could then be made as to whether the applicant network should enjoy continuing private status. But, this should be a secondary question. In Powerco's view, the GIC's initial focus should be on whether a principled reason for an exemption exists at all.

#### **Objectives of fairness and sustainability**

35. Exempting merchant distributors will have an impact on fairness of the gas system, particularly to end consumers. One function of the Gas (Downstream Reconciliation) Rules 2008 is to provide for the allocating of common costs across network users. In a duopoly market, both suppliers are ultimately accountable for the provision of an open access transportation service, and consequently they should both contribute towards meeting the common costs arising from open access.
36. At the GIC's 31 March 2008 workshop, there was a related discussion as to the weighting of the objectives in section 43ZN of the Gas Act, and those in the 2008 GPS. The 2008 GPS states:

*The Gas Act 1992 sets out the principal policy objective for Gas Industry Co., when recommending rules or regulations for wholesale market, processing facilities, transmission, and distribution of gas, as follows: "To ensure that gas delivered to existing and new customers in a safe, efficient, and reliable manner."*

*It is the Government's objective that when recommending rules, regulations or non-regulatory arrangements Gas Industry Co. applies this policy objective to all its work.*

*It is also the Government's objective that Gas Industry Co. takes account of fairness and environmental sustainability in all its recommendations. **To this end, the Government's objective for the entire gas industry is as follows:***

*To ensure that gas is delivered to existing and new customers in a safe, efficient, fair, reliable and environmentally sustainable manner.*

*It is against **this objective** that Gas Industry Co. must have regard when making recommendations for rules, regulations or non-regulatory arrangements for any part of the gas industry and against which it must report. [Emphasis added]*

37. Powerco believes the GPS clearly requires the GIC to have equal regard to fairness and environmental sustainability as it does to safety, efficiency and reliability. The GIC is not afforded any discretion to subordinate the fairness element, by "having regard" to fairness while "ensuring" the efficiency, reliability or safety of the gas industry. Rather, it is charged with ensuring all five objectives specified in the GPS.
38. Powerco believes that all customers are entitled to the same benefits and protections which the gas governance arrangements provide. A fair system does not unjustly discriminate or disadvantage one consumer over another. As noted in Powerco's submission on *Nova Gas Ltd Application for Exemption to Switching Rules*, Powerco outlined that any attempt by Nova to remove itself from the switching registry or not clearly identifying end users may lead to cost allocation inequities. For example, if Nova is granted a single ICP per gas gate it attaches to, then GIC levies would only apply to that ICP. GIC cost recovery then must be placed across a smaller group of users. This would lead to a competitive advantage for the Private Network and disadvantage other customers.

## **Discussion on areas of regulation**

### *Contract terms and conditions*

39. The GIC is already progressing a project on retailers terms and conditions and Powerco believes that Nova's contracts should be included as part of any regulatory outcome of this project. Powerco agrees with the discussion paper that private merchant distributors should not be exempt from regulation specifying standard terms and conditions for retail supply contracts, particularly provisions aiming to protect the positions of low-income customers. A bypass network facing competitive pressure has a clear incentive to inhibit customers switching and include terms and conditions such as matching clauses and roll-over clauses.
40. The GIC must consider the best way to protect all end users against any anti-competitive terms and conditions, while not imposing standard requirements. Powerco noted that in the GIC's submission on *Current issues for Domestic and Small Business Gas Consumers* that the GIC makes a comparison between the Victorian Energy Retail Code and the draft GIC Draft Model Contract Guidelines. The GIC and the Victorian authorities have developed guidelines rather than explicit Terms and Conditions as an option to protect end users. Powerco supports the use of such guidelines, but believes they could be strengthened by specifically referring to term and termination clauses and excluding clauses (e.g. matching and roll over clauses).

### *Information disclosure*

41. There has historically been a low level of transparency of private networks. For example, Nova bundles prices and does not disclose the cost of each service within the total price. The practice of bundling masks inefficiencies of the bypass network, and does not allow the end user to make a fair comparison of prices against open access networks. Open access networks on the other hand, provide transparent pricing to end users via the publication of standard network tariffs and the issuing of special pricing to all Retailers including the private network retailer.
42. Transparency across reconciliation, switching and end user information is key for end users to be informed customers and promote competition between networks. Any ability by one party to conceal information or be exempt from information

disclosure may allow information and price gaming to take place "unchecked". Therefore Powerco supports the inclusion of all parties in a transparent, cost effective and uniform disclosure environment.

### *Switching*

43. Powerco does not support the exemption of a merchant pipeline from the gas switching registry. Powerco considers that this would be anti-competitive and against the interests of end users. Throughout consultation on the gas switching registry Powerco has consistently submitted that it is imperative that all industry participants, including Nova, are included in the registry.
44. A key benefit of the registry will be to increase transparency of pricing arrangements associated with network services and in doing so enhance competition between network operators. Customer switching has historically occurred between Nova's network and adjacent open access networks (and vice versa) to the benefit of customers, and ensuring equality of registry requirements will help ensure balanced and equitable competition is maintained. Granting this exemption to Nova would lead Powerco to question the capability of the GIC to meet its statutory obligations and lead Powerco to consider our degree of participation in the registry. Powerco has provided more detail on this issue in its submission to the GIC on 10 March 2009.
45. Thank you for considering the points in this submission. I am contactable on 06 759 6216 if you would like to discuss any aspects in more detail.

Yours Sincerely



**Paul Goodeve**  
Regulatory and Business Manager

