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Dear Gael

## Switching Arrangements for the New Zealand Gas Industry – Part 2

Genesis Power Limited trading as Genesis Energy welcomes the opportunity to provide comments to the Gas Industry Company (GIC) on the discussion paper entitled 'Switching Arrangements for the New Zealand Gas Industry – Part 2' dated 31 August 2006. Genesis Energy has reviewed the discussion paper and is pleased to have the opportunity to respond to the issues raised in it.

With the exception of some comments below, Genesis Energy's responses to the specific consultation questions, including its comments on those areas on which Genesis Energy would like further consideration, are attached to this letter as Appendix One.

### Comments on the Gas Industry Company's General Approach

Genesis Energy continues to maintain that consistent with the co-regulatory model and the size of the industry, and despite claims to the contrary, there *is* an intermediate step of *mandatory self-governance* that is clearly framed and appropriate to the distinctive co-regulatory model and its particular nuances. Genesis Energy considers that such an approach would be:

1. more cost-effective than a regulated solution; and
2. capable of delivering on the Gas Industry Company's objectives.

Given this, Genesis Energy is disappointed that the Gas Industry Company has not sought to give effect to an industry-based compliance solution. This disappointment is accentuated when considered in the context of the Gas Industry Company's own summary of the feedback it received on its draft compliance and enforcement regime. For example:

"There was general support for improved compliance in the gas sector and many submitters agreed with the analysis in the paper. However there was relatively little support for the proposal."<sup>1</sup>

"Genesis suggested that the proposal was inconsistent with the co-regulatory framework which encourages industry-led solutions and arrangements without the need for rules and regulations. Other submitters voiced concerns that the Gas Industry Co may be premature with its preference for regulations and rules over a contractual approach to enforcement."<sup>2</sup>

"There was limited support for a Rulings Panel as presented in the paper. However, generally participants preferred to rely on bilateral enforcement for contractual arrangements, using arbitration and the court system as deemed necessary."<sup>3</sup>

Genesis Energy considers that such comments should have seen the Gas Industry Company redouble its efforts to search for an industry-based arrangement that delivered on its obligations under the Act and government's expectations as set out in the Government Policy Statement. While the Gas Industry Company, to its credit, did make efforts to scale back the intrusiveness of the compliance proposal, the concerns expressed were more fundamental than whether the proposed regime was fit for purpose – the primary concerns related more to the desire of industry participants that they first be provided with an opportunity to demonstrate their ability to hold themselves accountable for the enforcement of the rules by way of a multi-lateral contract.

Genesis Energy continues to believe that the burden of proof is on the Gas Industry Company to demonstrably prove that an industry-based arrangement, similar to that which existed successfully under the pre-regulated electricity market of NZEM and MARIA can not operate successfully in the context of the gas market nor meet the objectives set out in the Gas Act or the Government Policy Statement. Genesis Energy is not aware of any information that suggests that the self-regulatory enforcement regime of the electricity industry, when operated under the auspices of the NZEM and MARIA, did not operate effectively in ensuring the integrity of the rules. Indeed, there is a case to

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<sup>1</sup> Decision Paper on Modified Arrangements for Compliance and Enforcements (sic) Arrangements for Retail Gas Market Registry and Switching (undated), page 5.

<sup>2</sup> Op cit, page 5.

<sup>3</sup> Op cit, page 6.

answer that the regime under NZEM and MARIA was considerably more effective than the regime which replaced it.

## Comments on the Specifics of the Gas Industry Company's Proposal

Despite the immediately preceding comments, Genesis Energy acknowledges the low likelihood of the Gas Industry Company now moving to an industry-based compliance regime for the switching rules. Given this, Genesis Energy has some comments on the Gas Industry Company's approach as currently proposed. These are:

1. Genesis Energy is pleased to note the inclusion of an early resolution process into the proposed model. A concern however, still remains regarding the publication of what Genesis Energy would consider alleged breaches but which have been described, in the discussion paper and at the Gas Industry Company's workshop on Thursday 27 September 2006, as breaches. It is Genesis Energy's opinion that for reasons of natural justice, any report of a breach, other than self-reporting, must only be considered to be an "alleged breach". To this end, Genesis Energy would propose that Registry Operator's breach notices to the Market Administrator be renamed to that of "notices of alleged breach";
2. "Notices of alleged breach" must not be published. As discussed at the Gas Industry Company's workshop, Genesis Energy considers that the publication of such notices are:
  - a. Simply unproven allegations of breaches that have not been subjected to any independent analysis as to their veracity; and
  - b. Not meaningful to either consumers or industry participants to the extent that they do not indicate an actual breach of the rules.

As such, the publication of alleged breaches - to the extent that they do not contribute towards providing a high degree of confidence that the rules will be adhered to (the proposed regulatory objective) – will simply create 'white noise' in the process that is unwarranted and a distraction.<sup>4</sup> Genesis Energy contends that publication should be reserved only for *proven* breaches of the rules;

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<sup>4</sup> It is argued that publication of the alleged breaches by the Market Administrator is required in order for the full extent of the parties to the alleged breach to be determined with confidence (paragraph 6.11). Genesis Energy does not consider this to be so. Indeed, Genesis Energy contends that publication of alleged breaches (presumably on the Gas Industry Company's website) is a passive means of communication and that it is more likely for the parties to any alleged breach to be discovered via the Market Administrator's initial processes of information discovery.

3. The complexity inherent in determining whether an alleged breach is material.<sup>5</sup> Genesis Energy notes that there are *fifteen* criteria proposed as factors to be taken into account when determining materiality. The sheer quantum of potentially conflicting criteria is likely to:
  - a. result in uncertainty regarding decisions on materiality – in other words, participants are likely to be unsure how the criteria are being applied in practice;
  - b. lead to participants to game or worst still, litigate the Market Administrator's decisions in an effort to persuade the Market Administrator to weight certain criteria higher than others; and
  - c. create delay in reaching decisions as the Market Administrator seeks to apply the myriad of criteria to real world cases.

Rather than the fifteen criteria, Genesis Energy instead proposes that the concept of *primary* and *secondary* criteria be implemented. In essence, Genesis Energy considers that the primary criteria should be limited in number (to, for example, no more than two) and be relatively 'black or white' in their application. Such criteria could, for example, be based around a dollar threshold and whether the alleged breach has a direct impact on consumers. Other criteria (such as the fifteen currently proposed or some subset of them) could be applied as the secondary criteria that the Market Administrator could draw on to influence/support its decision based on the primary criteria. Genesis Energy believes that such an approach will avoid the problems outlined above; and

4. While rules are undoubtedly an important element in the Gas Industry Company's compliance 'armoury' it is not the only element – the pro-active education of participants is as, if not more, important than the rigorous application of the rules themselves. In light of this, Genesis Energy would find it useful if the Gas Industry Company were to clearly enunciate its overall compliance 'philosophy' or the type of approach it will take with regard to enforcing the rules. For example, that:
  - a. the Gas Industry Company will seek to inform and educate industry participants about the rules, their use and applications as a preventative means to avoid enforcement action;
  - b. all parties going through the process can have confidence to disclose full details of any information relevant to the investigation as the Gas Industry Company would ensure that:
    - i. any information provided during the investigation phase will be confidential; and

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<sup>5</sup> Switching Arrangements for the New Zealand Gas Industry – Part 2 Compliance and Enforcement Arrangements -31 August 2006. Appendix 4, clause 15.

- ii. the process will be focussed on correcting non-compliance and preventing future non-compliance rather than simply being punitive in nature;
- c. The Gas Industry Company will ensure that corrective action is initiated to:
  - i. minimise any market consequence that stems from the alleged breach; and
  - ii. seek to minimise the repeat of the non-compliance; and
- d. Punitive action would only be taken against a participant if:
  - i. there was market consequence from the breach that was not resolved by the affected parties; or
  - ii. there was a pattern of repeat 'offending'.

Other comments on the Gas Industry Company's proposals are included in Genesis Energy's responses to the specific consultation questions.

Genesis Energy would be happy to discuss any aspect of this submission with the Gas Industry Company should it wish to do so. Please do not hesitate to contact either myself on [john.carnegie@genesisenergy.co.nz](mailto:john.carnegie@genesisenergy.co.nz) or 021 375 061, or Tracey Kaio on [tracey.kaio@genesisenergy.co.nz](mailto:tracey.kaio@genesisenergy.co.nz) or 021 778 375.

Yours sincerely



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Genesis Energy

## Appendix One: Responses to Specific Consultation Questions

QUESTION	COMMENT
<p><b>Q1:</b> Do submitters agree with this Regulatory Objective? If not, what do you think the regulatory objective should be?</p>	<p>No. As set out in its previous submission on this issue, Genesis Energy considers that a more appropriate objective is:</p> <p>“An effective compliance and enforcement regime that provides an appropriate balance between integrity of the rules and efficiency.”</p> <p>In Genesis Energy’s view, this objective is:</p> <ol style="list-style-type: none"> <li>1. superior to the objective as stated in paragraph 2.7 of the consultation paper; and</li> <li>2. appropriate irrespective of whether the mechanism used to implement it is regulations, rules or a industry-based arrangement.</li> </ol> <p>Importantly, the cross-reference contained in the proposed objective to:</p> <p>“....and thereby contribute to the better achievement of the Government’s policy objectives for the retail sector of the gas industry.....”</p> <p>while seemingly appropriate, effectively imports into the objective statement any number of unspecified (and potentially conflicting) aspects into it, thereby rendering it so broad as to be effectively meaningless.</p>
<p><b>Q2:</b> Do submitters agree with the analysis of the Proposal? If not, please state your reasons?</p>	<p>Genesis Energy supports in the first instance, the implementation of an industry-based arrangement. Having said that, the detailed statement of the proposal as asset out on pages 18 – 22 of the consultation paper, with the amendments outlined in the attached letter, does not appear to be unreasonable.</p>

QUESTION	COMMENT
<p><b>Q3:</b> Do submitters agree this Proposal complies with section 43N of the Gas Act? If not, please state your reasons.</p>	<p>No. Genesis Energy does not consider that the Gas Industry Company have given appropriate consideration to the implementation of an industry-based arrangement, and in not doing so, has over-stated (relative to the Gas Industry Company's preferred regulatory approach) both the likely costs of an industry-based arrangement and the difficulties in implementing such an approach.</p> <p>In general, Genesis Energy considers that the objectives stated as tangible benefits of the regulated approach could uniformly be achieved under a well-crafted industry-based arrangement. For example, paragraph 7.9 states that:</p> <p style="padding-left: 40px;">"Gas Industry Co considers that consumers should be able to report a breach of the rules and seek to have them enforced"; and</p> <p style="padding-left: 40px;">"Gas Industry Co considers that the Registry Operator should be required to report any rule breaches it detects when operating the central registry as a means of ensuring comprehensive compliance with the central registry and switching system."</p> <p>Genesis Energy does not understand why the attainment of either of these is specific to a regulated solution and can not be delivered under an industry-based solution.</p>
<p><b>Q4:</b> Do submitters have any other information that they consider is relevant to the assessment of the Proposal?</p>	<p>Please see the attached letter for Genesis Energy's views of the appropriateness of an industry-based arrangement as a preferred mechanism to implement a compliance regime for the switching rules.</p>

QUESTION	COMMENT
<p><b>Q5:</b> Do submitters agree that the benefits relative to the costs of the Proposal are likely to be superior to a voluntary compliance and enforcement regime?</p>	<p>No. No obvious attempt at a quantitative cost-benefit analysis has been undertaken. To this extent, statements such as:</p> <p style="padding-left: 40px;">“The Gas Industry Co has concluded that the proposed regulated compliance arrangements will offer a positive net benefit, relative to a voluntary enforcement arrangement....”</p> <p>are highly subjective and can not be relied upon as conclusive evidence.</p> <p>In addition, Genesis Energy is surprised that in support of the regulated approach some reliance is placed on the possibility that, if used as a benchmark model for other arrangements that its establishment costs can somehow be spread over other arrangements, thereby enhancing its net benefit. Genesis Energy has the following observations to make in this regard:</p> <ol style="list-style-type: none"> <li>1. there is no mention in the switching rules consultation paper that the development costs associated with those rules will (or even can) be redistributed. The expectation is that existing participants are paying for their development and as such these costs will be considered to be ‘sunk’ and will advantage the cost-benefit analysis of those future arrangements, but not for the switching arrangement – these costs must be fully included; and</li> <li>2. as the other arrangements have not yet been developed, the Gas Industry Company can only speculate as to the relevance, or not, of the compliance regime that it has developed for the switching rules.</li> </ol>
<p><b>Q6:</b> Do submitters agree that the Proposal will lead to a higher level of compliance than a voluntary compliance and enforcement regime?</p>	<p>No. There is no tangible evidence to suggest such an outcome is more or less likely to be achieved.</p>
<p><b>Q7:</b> Do submitters agree that the benefits relative to the costs of the Proposal are likely to be superior to alternative designs? If not, please specify which particular aspects of the design should be amended, stating reasons.</p>	<p>No. Please see the response to Q5.</p>
<p><b>Q8:</b> Do submitters agree that the Proposal meets the Regulatory Objective? If not, why?</p>	<p>Yes, but only to the extent that the Gas Industry Company considers that a regulated solution is more desirable than a non-regulated one.</p>

QUESTION	COMMENT
<p><b>Q9:</b> Do submitters believe the proposed compliance regulations adequately reflect and govern the Proposal? If not, please provide all drafting amendments in mark-up.</p>	<p>Yes, however, Genesis Energy has, in the attached letter, suggested some improvements that it wishes the Gas Industry Company to consider in its on-going development of the regulated solution.</p>
<p><b>Q10:</b> Do submitters agree with the funding options for the Proposal? If not, please state your reasons</p>	<p>Genesis Energy agrees that the costs of the proposed model be recovered by way of a levy. However, Genesis Energy is concerned that this levy may be confused with the current Gas Industry Company levy which is borne by wholesalers and retailers. Any levy imposed should be separate to the current Gas Industry Company levy and be recovered from all participants of the gas switching registry.</p>
<p><b>Q11:</b> Do you have any other comments on the Proposal?</p>	<p>Genesis Energy has some additional issues it wishes to provide comments on. These are:</p> <ol style="list-style-type: none"> <li>1. Any decision to appoint or change the Investigator and/or Rulings Panel should be done in consultation with all participants and not by the Gas Industry Company alone. It is important that these positions are occupied by individuals/companies of good standing and knowledge;</li> <li>2. While the view expressed in 1 above also applies to the position of Market Administrator, Genesis Energy's preference with respect to the role of market Administrator is that it be retained by the Gas Industry Company. Genesis Energy has reached this view on the basis that: <ol style="list-style-type: none"> <li>a. It is a role which requires strong independence and that this is unlikely to be found in any other participant;</li> <li>b. The critical nature of the role is such that a split between accountability for delivery and responsibility for delivery is considered to be highly problematic. Both should rest in one organisation (in this case the Gas Industry Company); and</li> <li>c. The difficulty in aligning the incentives of a third-party service provider appropriately. Ultimately service providers will be incentivised by the form of the payment method. Incentives will vary depending on whether the method of payment is fixed, variable, or some</li> </ol> </li> </ol>

QUESTION	COMMENT
	<p>combination. Experience suggests that with these types of services, the transaction costs associated with ensuring the appropriate incentives outweigh the benefits of third-party delivery.</p> <p>Therefore, Genesis Energy recommends that the definition of market administrator be amended to read “means the co-regulatory body”; and</p> <p>3. Part 3 of the draft Gas (Compliance) Regulations 2006 deals with the orders which the Rulings Panel may make while para 49 deals with a monetary penalty of up to \$20,000.00. Genesis Energy would like clarification as to where this penalty would be used. There are, for example, several ways in which this could be distributed:</p> <ul style="list-style-type: none"> <li>a. to a charitable organisation as agreed to by industry participants; or</li> <li>b. to off-set the Gas Industry Company’s future funding requirements of participants; or</li> <li>c. back to industry participants via some methodology.</li> </ul> <p>Genesis Energy would, as an initial suggestion, propose that as any penalty would be punitive as opposed to compensatory it should not therefore in anyway go back to participants (or any subset of participants such as those who may have been adversely affected by the breach).</p>